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The Dutch Disadvantage?

Is regulation and policy in the Netherlands putting local financial institutions at a disadvantage in comparison to peers abroad?

September 2017


pantos
Ring Rotterdam
Den Haag
Hoek van Holland
Havens 100-1000
A4

Contents

Foreword

The financial sector fulfils several important roles in the economy. Financial institutions provide the economy with credit and liquidity and supply risk management services (insurances, pensions) to households and businesses. As such, financial institutions contribute to a higher level of economic activity than would be attainable in the absence of these services.

The financial sector is more regulated than other sectors, because of its crucial role in the economy and the fulfilment of its public tasks. Banks are highly interconnected. They provide liquidity to each other and invest in similar assets. The bankruptcy of one bank can lead to the fall of other banks as well. Fear of public panic and an implosion of the financial sector forced governments to set up a public safety net for the financial sector. But arrangements such as the deposit guarantee scheme (DGS) increase the risk of 'moral hazard'. This means that financial institutions take more risks, because they know they won't have to pay the whole bill if these risks materialise. When looked at from a social perspective, shareholders of financial institutions will underinvest in the institutions' safety.

Another reason for market failure is the information asymmetry between customer and supplier, which is significant in the case of financial products. This asymmetry arises as consumers purchase important, complex products, such as a mortgage, life insurance or a pension on a limited and non-repeat basis. If consumers discover a problem with their product it will be long after the original purchase and he or she will have limited options to switch to alternative products.

Considering the importance of the financial sector, added to the huge consequences in case of market failure and collapse, there are very good reasons to have regulations in place. And this is exactly what happened after the financial crisis when governments implemented a lot of new regulations for banks and insurers.

When it comes to the implementation of international regulation, it seems to be part of Dutch culture to complain about Dutch rules being relatively strict compared to other countries. Advocates of this belief suggest that we implement all international regulation as it was written, while other countries choose a more pragmatic and favourable approach. Even worse, we regularly pile extra national regulation on international regulation. Indeed, in the Dutch political and societal debate it has also been frequently suggested that financial regulation in the Netherlands is stricter than the regulation in other countries. This is believed to lead to unfair competition for Dutch financial institutions and to the Netherlands becoming a country that is less attractive to establish local presence.
We conducted a thorough study into this (perceived) Dutch disadvantage and one of the main conclusions is that, across the board, the Netherlands is not stricter than other countries. Indeed, regarding some important aspects regulation in the Netherlands is actually less strict than in other countries. For example, Dutch banks were not required to split their retail business and investment banking business, or to issue new equity to improve capital ratios.

In an international perspective, the Netherlands is stricter in a couple of areas. A bonus cap which may not exceed 20% of the fixed remuneration is a notable example. At the same time, we found that the consequences of this strict regulation are not as straightforward as has often been suggested. Each measure has its potential effects but they are not the same for every financial institution or for every legal form. Strictness as such doesn't necessarily affect the attractiveness of the Netherlands as a place to establish a head office. Financial institutions who choose the Netherlands for their company's headquarters may benefit from it as well.

We hope this report will contribute to a balanced view of the Dutch regulatory landscape.

Jan Willem Velthuijsen
Chief Economist PwC NL

Management summary

Management summary

The financial crisis in the first decade of this century revealed not only the important vulnerabilities in the financial system but also the shortcomings of the then prevailing regulation. As banks and insurers were severely challenged or, in the worst case, failed during the global financial crisis, policymakers felt an increased need to adapt or implement regulation in order to prevent a new crisis.

International cooperation and alignment is an important way to prevent the circumvention of rules via international regulatory arbitrage. A global agreement was reached regarding the rules for capital and liquidity requirements for banks (Basel III). For other types of regulation, such as rules governing the remunerations, agreements between EU countries proved feasible, yet global agreements could not be achieved. Some EU countries, including the Netherlands, also introduced national laws.

In the Dutch media it has been frequently suggested that financial regulation in the Netherlands is stricter than the regulation in other countries and that this relative strictness is leading to: a) an exit of financial institutions from the Netherlands b) the Netherlands becoming less attractive for entry and c) unfair competition for Dutch financial institutions.

In this study we evaluate these assumptions.

Main findings

- One cannot conclude that the Netherlands is stricter than other countries across the board. The regulation in the Netherlands is actually less strict than other countries regarding some important aspects. Unlike some other countries, the Netherlands did not require banks to split their retail and investment banking businesses or to issue new equity to improve capital ratios.
- The Netherlands is stricter in an international perspective concerning four areas: remuneration policy (bonuses), the leverage ratio for banks, a ban on inducements, and assessment procedures for executives of financial institutions.
- The effects of the relative strictness can vary between different types of financial institutions or different types of entry. For example, the relative strictness of the Dutch regulation on bonuses can increase the attractiveness of the Netherlands for locating bank branches but can decrease the attractiveness of the Netherlands for locating subsidiaries.
- Deviations from supranational financial regulation by the Netherlands can create a negative perception abroad, despite the ultimate effects of these deviations being negligible or small.
- The effects of stringent financial regulation are complex and often ambiguous. This supports the need for more in-depth research and analysis.

Detailed conclusions regarding financial regulation in which the Netherlands is stricter i.e. 'deviations'

Bonus cap

In the Netherlands, the variable part of remuneration is not allowed to exceed 20% of the fixed remuneration. This is stricter than the 100% cap used elsewhere in the EU. The Dutch regulation on bonuses in the financial sector may affect decisions if and how to enter the Dutch market.

The relatively strict rules on bonuses may lead to higher labour costs, as banks and insurance companies may raise fixed salaries to offer a competitive remuneration. A higher fixed remuneration raises labour costs,

as certain expenses are related to fixed and not to variable remuneration, such as pension contributions. The Dutch bonus policy for the financial sector can also lead to lower flexibility: bonuses are often linked to the financial performance of the institution, while fixed salaries are not. So higher fixed salaries are also potentially increasing the default risk of an institution, especially if the year-to-year profits are uncertain.

Although scientific research is ambiguous about the relation between bonuses and risk-taking, bonuses are considered to stimulate excessive risk-taking and focus on short-term profit. If this is true, a cap on bonuses will enhance financial stability.

The bonus cap may decrease the attractiveness of the Netherlands for the headquarters of banks. On the other hand, they might benefit from increased financial stability. For branches of banks the attractiveness increases because the bonus cap is not applicable. As such, the regulation stimulates the entry of branch banks more than the entry of headquarters and subsidiaries of banks. For insurance companies the effects are not the same because the bonus cap applies to all entry forms, including branches.

The competitive position of Dutch banks and insurance companies on the domestic or international market is likely to be negatively influenced, although, at the same time, they might benefit from increased financial stability.

Leverage ratio

In the aftermath of the global financial crisis, authorities in Europe, North America and Asia strived for the development of common rules to enhance the solvability of banks and, as such, their resilience against new headwinds. Through the Basel Committee on Banking Supervision, a number of countries developed a new reformed framework, commonly referred to as Basel III.

Basel III was implemented in the European Union by means of the Capital Requirements Directives (CRD IV), which sets the minimum leverage ratio for banks at 3%. The Dutch government aspires for a higher ratio of 4% for system relevant ('too big to fail') banks. This is not yet a legal requirement.

A higher leverage ratio may raise the funding costs for financial institutions, as equity financing is more expensive than debt financing, due to the tax subsidy for debt and the Deposit Guarantee Scheme. On the other hand: a high leverage ratio may signal strength.

The net effect of a higher leverage ratio on the attractiveness of the Netherlands is ambiguous and depends on the type of entry (headquarters, subsidiary or branch) as whether the bank is a system or non-system bank. We expect that the effects are small because the discrepancies with other countries are small: most comparable banks elsewhere already have leverage ratios higher than 3%.

The effect on the competitive position of Dutch banks on the international market is ambiguous as well and also depends on several factors.

Ban on inducements
Since 2013, Dutch legislation prohibits inducements for all advisers and intermediaries of (complex) financial products for retail clients. Inducements – or commissions or provisions – are payments to distributors or advisers in exchange for the sale of a financial product. Advisers and intermediaries are allowed to receive rewards or compensation for independent investment advice or asset management services, but only directly from clients, and not from third parties.

The underlying principle for this inducement ban is that investment service providers must act in the best interest of their clients. When advisers or intermediaries receive inducements from a third party in exchange for services or products provided to a client, they might be inclined to raise this commission income, instead of providing advice aligned with a customer's best interest and circumstances.

The net effect of the Dutch inducement ban on the attractiveness of the Netherlands for suppliers of financial products and financial advisers is ambiguous. We expect that the ban reduces demand for financial advice and the demand for certain financial products. We also expect that the ban increases entry barriers for the suppliers of financial products since it makes it difficult to efficiently incentivise existing distributors to promote the products of the entrants. At the same time advisers and suppliers may benefit from enhanced trust in the financial sector.

The ban on inducements does not affect the competitive position of Dutch institutions on the international market appreciably.

Assessment procedure
Dutch supervisors Authority Financial Markets (AFM) and the central bank (DNB) screen nominee board members, supervisory board members, and some other key officials of financial institutions who operate under their supervision. Candidates can only take up their new responsibilities after a positive ruling from AFM or DNB. In a European context, the Dutch assessment is – along with the British screening procedure – relatively elaborate and though, including a preliminary assessment and, where deemed necessary, an interview. In other European countries the screening is often limited to an administrative assessment.

The net effect of the more stringent assessment procedures of AFM and DNB depends on the form of entry. As in the case of the bonus cap, we see an asymmetry in the effects on headquarters, as well as on branches, because the regulation doesn't apply to branches of European financial institutions.

The screening procedures can lead to higher costs and uncertainty for candidates and greater difficulties to attract candidates for key positions. A possible positive effect of the screening is that it can increase the quality of employees in key positions.

The effect of the competitive position of Dutch institutions on the international market is also ambiguous.

Introduction

- Methodology
- Identified differences
- Important constructs

New regulation was introduced in response to the financial crisis. The regulatory response in the Netherlands is perceived to be relatively strict. PwC examines how Dutch regulation compares to other countries

The global financial crisis has hit the Netherlands hard

The Netherlands was hit hard by the global financial crisis. The Dutch part of Fortis (including activities of ABN AMRO) and SNS Reaal were nationalised. DSB and Icesave collapsed, leading to claims on the Deposit Guarantee Scheme. ING and Aegon received state support to strengthen their capital positions and to gain trust from the markets so that these entities could survive.

Regulation has been introduced to limit the impact of a new financial crisis

In response to what happened and public indignation, policymakers took measures that should prevent similar events from recurring in future. As the crisis was global in nature, making international regulation stricter was an obvious option, resulting in e.g. Basel III and Solvency II. Although these regulatory guidelines are meant to improve comparability and equality across borders, deviations at a national level exist.

The Netherlands is perceived to be stricter than other countries

In the Dutch media it has been frequently assumed that financial regulation in the Netherlands is stricter than the regulation in other countries and that this relative strictness is leading to a) an exit of financial institutions from the Netherlands b) the lessening of the attractiveness of the Netherlands for entry and c) unfair competition for Dutch financial institutions.

In this report we identify differences between countries and analyse their potential effects

In this study we evaluate the assumption that the Netherlands is relatively more strict and that the relative strictness has negative effects.

The study focuses on identifying the differences between the Dutch regulation and international counterparts and on the potential effects of possible differences.

The analysis of the actual consequences of the differences is not part of the scope.

Methodology

This study investigates the main differences in regulation between the Netherlands and comparable countries, as well as the potential effects of these differences

Research process

Identification of the main differences

We identify the main differences concerning the *legal framework*, and *supervision*.

Research of the main differences

We *verify* the identified *main differences*.

Analysis of the effects of the main differences

We analyse the *effects* on the *competitive position* of *Dutch financial institutions domestically* and *abroad*, as well as effects on the *attractiveness of the Netherlands* for financial companies to establish local presence.

Our research methods

Desk research
- Quick scan to identify the main differences.

Interviews
- Identify main differences.
- Test the validity of the main differences found in desk research.

Our research methods

Desk research
- Extensive research to verify the differences based on an analysis of relevant legislation and (guidance) documents of supervisors.

Interviews
- Deep dive into the legal and supervisory framework.

Our research methods

PwC analysis
- Analysis of the effects of the main differences based on literature and PwC expertise.

Interviews
- Interview several leading academics to validate the effects of the main deviations.

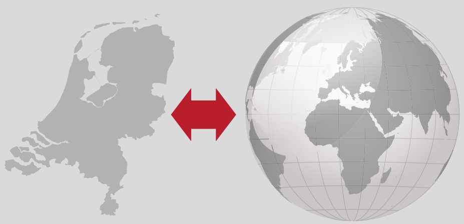
We compare the Dutch legal framework with other Western countries and the European Union. The emphasis is on banks and insurers

Financial institutions

In this study, we focus on the following financial institutions:
- Banks
- Insurers

If specific regulation or supervisory stance has a particularly large effect on a different type of financial institution, we will include this type of institution in our analysis.

International comparison



We compare the Netherlands mainly with European Union member states, but other Western countries like the United States and Switzerland are also taken into account.

We start our analysis by comparing the Dutch legal context with the supranational European context. We identify the main deviations. Subsequently, we investigate if other European countries deviate from the European legal framework as well, and compare this with the Dutch situation.

We use a standard format with icons to illustrate the effects. The size of the icons represents the magnitude of the effect, colour represents the direction

We analyse several individual effects of the differences assuming ceteris paribus
This implies that we look at the effect of differences in isolation. All other conditions that might differ between countries or companies are assumed to remain constant.

We distinguish four effects:
- Positive
We expect the difference contributes to the attractiveness of the Netherlands, or to the competitive position of Dutch financial institutions on the Dutch or international market.

- Neutral
We expect that the net effect of the difference does not influence the attractiveness of the Netherlands, or the competitive position on the Dutch or international market.

- Negative
We expect the difference decreases the attractiveness of the Netherlands, or the competitive position on the Dutch or international market.

- Ambiguous
We cannot assess the overall effect of the difference because there are either several positive and negative effects at play, and it is not evident which one will dominate, or there are several possible scenarios with different outcomes.

We classify the effects in three different magnitudes, ranging from negligible to large:
- Negligible
An effect is deemed negligible if there is influence on the attractiveness or competitive position of Dutch financial institutions on the Dutch or international market, but this is so small that we do not consider the impact to be relevant.

- Small
The effect is considered small if we expect the effect stemming from a deviation will have minor consequences.

- Large
The effect is considered large if we expect the effect to have material impact on the attractiveness and competitive position.

We illustrate these effects using icons of different sizes and colours. In the table below, the different icons are explained.

The potential effect of the deviation on the attractiveness of the Netherlands is:	Negligible	Small	Large
Positive			
Neutral	*Not applicable*		*Not applicable*
Negative			
Ambiguous	*Not applicable*		*Not applicable*

Identified differences

Through desk research and interviews, we identified several differences. We have made a selection of these based on importance and feasibility. We will cover these topics in this report

Bonus cap

In the Netherlands, the variable part of remuneration is not allowed to exceed 20% of fixed remuneration. This is much stricter than the 100% cap used elsewhere in the EU.

The bonus cap aims to lessen the risk-taking behaviour of financial institutions (DNB). As private costs are lower than public costs, financial institutions might choose a remuneration policy that incentivises a level of risk-taking that is not optimal from a public point of view. If so, welfare could increase if a bonus cap sets the level of risk-taking at a level optimal from a public point of view.

Leverage ratio

The minimum leverage ratio for banks in the Netherlands and the UK is high compared to other European countries.

A minimum leverage ratio is introduced to prevent excessive leverage that may lead to failure and a higher public than private cost. A (higher) leverage ratio shifts more risk to shareholders, and thus reduces public cost that may result from excessive risk-taking by the financial institution (DNB).

Ban on inducements

In Europe, mainly the UK and the Netherlands have a stricter ban on inducements or provisions.

Inducements might have provided the incentive for financial advisers to base their advice regarding a financial product on the size of the associated inducement of the financial product. The ban on inducements was introduced to eliminate this incentive (AFM). Because of the profound information asymmetry in the financial sector, customers are not fully equipped to assess the quality of advice and products.

Assessment procedure

The screening of (candidate) executives differs strongly in Europe. The UK and the Netherlands have the most elaborate assessment regimes.

The assessment procedure is implemented to guarantee a minimum skill set for board members and employees in key positions at financial institutions. This procedure is intended to contribute to the stability and integrity of the financial sector (DNB).

Some topics that we do not analyse in detail are examined briefly in this section

Topics in short

In a few interviews, and during our desk research, several topics were identified that we do not analyse in detail. We will nonetheless briefly discuss these topics here to provide some context. This allows for a better assessment of the significant differences. The topics are as follows:

- Compulsory issuance of equity
- Separation of the retail and investment activities of banks

Compulsory issuance of equity

Under the Capital Purchase Program, initiated in October 2008, and in which more than 700 financial institutions participated until its close in December 2009, US banks improved their capital ratios by issuing equity (Ng et al., 2011).

Also, banks that failed stress tests in 2009 were forced to enhance their capital ratios mainly by means of equity issuance (OECD, 2014). All in all, US banks raised €190 billion in new capital between 2007 and mid 2013.

This is a relatively small amount compared to the €248 billion equity European banks issued in the same period. At the same time, total assets of European banks were five times as high as those of US banks (Castañeda, Mayes and Wood, 2016).

The Dutch Central Planning Bureau (CPB) constructed a sample of 46 European banks and 58 US banks to investigate equity issuance.

It concluded that between 2007 and 2013, equity issuance by European banks reached €250 billion, while that of US banks was of €150 billion (CPB 2014).

Dutch banks were not forced to improve their capital ratios by means of equity issuance. In the US, banks were in several instances obliged to do so, and as a result, achieved higher solvency ratios at an earlier time, which may have benefited their profitability.

Two interviewees we consulted argued that social costs would be lower if capital ratios of Dutch banks were strengthened through forced equity issuance, comparable to what happened in the US. Instead, banks choose to reduce assets and allocate net income to reserves to achieve this.

Separation of the retail and investment activities of banks

Despite a recommendation from a parliamentary committee ('Commissie De Wit'), the Dutch government decided not to force banks to separate the retail activities from the business or proprietary banking activities. Contrary to countries like the US, UK and Germany, the Netherlands does not currently have legislation forcing banks to separate activities perceived more risky from retail banking.

In 2010, a parliamentary committee chaired by Jan de Wit published a report with an evaluation of the Dutch response to the financial crisis and multiple recommendations for improvements. One of the recommendations was to separate deposit-taking bank activities from commercial banking (Rapport Commissie de Wit, 2010). This to ensure that the more risky commercial activities could not have a negative impact on the 'utility' function of deposit-taking activities in times of trouble.

The Netherlands has chosen not to force universal banks to split into an investment bank and a retail bank. The EU is working on legislation to determine which banking activities can be combined and which not

Topics in short (continued)

As there was no unanimous support for this recommendation, the Dutch Minister of Finance, De Jager, asked a new committee, chaired by Herman Wijffels, to further investigate how Dutch banks could potentially be restructured (Ministry of Finance, Sept. 2012).

In June 2013, the Wijffels committee recommended to maintain the universal banking model in which all activities can be combined in one organisation, provided proprietary trading activities are restricted. A complete separation or break-up was not advised, as it would restrict the ability to provide services such as risk management and underwriting.

The Dutch government adopted the recommendations of the Wijffels committee and did not support a break-up of banks. With respect to the separation of proprietary trading activities, it was decided to ultimately align rules with a directive from the European Council (Kabinetsvisie Nederlandse Bankensector, 2013).

EU regulation in the making

In response to the Liikanen report, which recommended a separation of banking activities into deposit-taking activities and other activities, the EC started to draft a proposal for the structural reform of EU banks (EC). In June 2015, it presented the European Parliament a 'first reading' of the proposal that can be negotiated in a final version of the directive.

The latest proposal does not seek a break-up of banking activities in a manner that Liikanen group envisioned, but a separation of proprietary trading from other banking activities. National supervisors can also decide to have activities such as market-making, risky derivatives and complex securitisation separated from 'core' banking activities. The rules will apply to large, system banks in particular in the EU (EC).

The United Kingdom, Germany, France and Belgium decided not to wait for EU-wide legislation on a split of banking activities, and implemented national laws

Topics in short (continued)

United Kingdom

In 2013, the parliament passed the last part of the Banking Reform Act and, as a result, bank reform could be implemented in line with recommendations of the Vickers committee (GOV.UK). The law forces banks to 'ring-fence' deposits of private persons and small enterprises from the trading floor by allocating retail activities in subsidiaries, legally, economically and operationally separated from other activities such as trading (GOV.UK).

The UK bank structure reform is more far-reaching than those of Germany and France as it aims to separate investment and wholesale banking activities from retail banking activities, and not just proprietary trading (Mayer Brown, 2015).

France

In July 2013, France enacted law no. 2013-672 on the 'Separation and Regulation of Banking Activities'. This law enforces the separation of any proprietary speculative activities of a bank, from retail and small business banking activities (AMF). Hedging, market-making, cash management and investment operations of financials groups are among the exceptions.

Germany

The German Bundesrat approved the 'Act on Ring-fencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups' in June 2013. As of July 2015, article 2 of this law prohibits credit institutions from specific risk-taking activities. A financial group may continue with these activities, but they need to be separated or ring-fenced. Several exceptions exist related to the nature and size of the risk-taking activities. For example, a trading portfolio should be larger than 20% of total assets, and activities such as hedging transactions for clients do not fall under the ban (BaFin).

Belgium

As of January 2015, Belgium implemented its national Banking Reform Act, which prohibits proprietary trading activities by Belgian credit institutions, either directly or via subsidiaries. Thus a separate legal entity has to do the trading. Under certain conditions, a Belgian credit institution may engage this legal entity in market-making or liquidity management activities (Norton Rose Fulbright).

United States

The so-called Volcker rule was added as section 619 to the Dodd-Frank Wall Street Reform and Consumer Protection Act. As of July 2014, this rule prohibits insured depository institutions and affiliates to engage in proprietary trading and have ownership interests in hedge funds or private equity funds (Federal Reserve). The Volcker rule prohibits proprietary trading rather than seeking separation via ring-fencing. This means that in the US, this kind of activity cannot take place within the banking group (Mayer Brown, 2015).

Important constructs

Box 1: Financial stability improves the attractiveness of a country for financial institutions

The relation between financial stability and the attractiveness of a country has not yet been validated empirically
A positive link between financial stability and the attractiveness of a country (for financial institutions) is generally implicitly assumed. This implicit assumption is, however, not yet validated by empirical evidence, demonstrating the benefit of financial stability for the environment in which financial institutions are active.

However, there is a positive relationship between financial stability and foreign investments
Several studies indicate that there is a positive relation between financial stability and foreign direct investment (FDI) (Albulescu, Briciu and Coroiu, 2010, Janicki and Wunnava, 2004). Moreover, there seems to be a positive relation between economic stability and FDI (Lim, 2001, Estrin and Uvalic, 2013).

The positive links between stability and FDI imply that a foreign firm is more likely to establish presence and become active in a financially stable country, which can be considered to have a more attractive business climate.

Also, there is a positive relation between financial stability and economic growth
The World Bank states that financial stability is paramount for economic growth. The Dutch Central Bank too stresses the importance of financial stability for a well-functioning economy and hence economic growth (please refer to e.g. DNB, 2014). Creel, Huberta and Labondance (2015) show that financial instability has a negative effect on economic growth.

Economic growth is an important determinant of financial institutions in their choice to enter a new market
Banks consider economic growth and, more importantly, the economic growth potential of countries, when they decide to make an entry (Focarelli and Pozzolo, 2005). The expected economic growth in a country is an important driver of the expected profitability of a local establishment. Hence, banks are more likely to enter a country if the expected economic growth is higher.

Box 2: Financial institutions might face a trade-off when it comes to countries with strict regulation: it increases costs, but it could also be beneficial for their reputation

On the one hand, stricter financial regulation and supervision increases the costs imposed on financial institutions

Usually stricter regulation and supervision raises the costs of an institution for several reasons. It can, for instance, limit the possibilities to offer certain products or raise the costs of a company. Costs related to compliance are likely to increase like other expenditure, such as operational costs or funding costs may rise.

On the other hand, stricter regulation can be beneficial for the reputation of financial institutions

Financial institutions of a high quality might deliberately choose a country with the stricter regulation and supervision in their location decision. This way, the institution signals that it is able to comply with the highest standards. The prerequisite for this is that regulation or supervision must be seen as a quality standard for the institution.

Regulation can contribute to the soundness of an institution, like the leverage ratio. A stricter regulation in this respect could be beneficial to the reputation of an institution as being sound and resilient against adverse conditions.

Therefore, the effect of stricter regulation on the attractiveness of a country is ambiguous

It is unclear if stricter regulation and supervision will increase or decrease the attractiveness of a country. As described above, stricter regulation is likely to raise costs, but it might also benefit the reputation of the institution and serve as a signal.

In two of the interviews we conducted for this research, this trade-off was mentioned as a likely effect of the stricter regulation in the Netherlands.

Other interesting thoughts…

Strict regulation can have a different short- and long-term effect on the reputation of the financial sector. If new stricter laws are adopted or the supervisory regime becomes tougher, the reputation of the financial sector is likely to decrease in the short term as a result of an increase in reprimands and fines. In the long run, institutions are likely to comply with this newer regulation. The stricter regulation and/or supervision is likely to result in less scandals and/or prevent financial institutions to face distress. Hence, the long-term effect on the reputation is likely to be positive.

Box 3: Passporting enables freedom of establishment and cross-border provision of services

Passporting facilitates access to the common market for financial institutions
Passporting refers to the right of regulated financial institutions in the EU or European Economic Area (EEA) to carry out permitted activities in any other of the 27 member states. Under the principles of single license and host country control, passporting enables freedom of establishment and cross-border provision of services.
The passporting regime is regulated by means of pan-European legislation such as Capital Requirements Regulation and Directive (CRR/CRD IV), Markets in Financial Instruments Directive (MiFID) and Payment Services Directive (PSD). In the Netherlands, this legislation is present in article 2 of the 'Wet op het financieel toezicht' (Wft).

Active abroad, but supervised locally
When regulated financial institutions wish to conduct similar activities in a country other than the home country, they need to register with the supervisory authorities of the host country. However, under the European passporting regime, they remain under the supervision of the authorities of the home country. The supervisory authorities in the home country of a financial institution are considered best capable to verify whether the institution meets all reporting requirements (Bierman, 2016). Accordingly, a financial institution that is active in the Netherlands and is passporting, does not fall under the supervision of either the DNB or AFM, but under that of the 'home supervisor'. However, supervision on integrity, payments and European Market Infrastructure Regulation (EMIR) falls under DNB supervision, regardless of a passport (DNB; Bierman, 2016).

Local presence or cross-border activity
There are essentially two ways in which passporting can be conducted. Either by establishing local presence in the form of a branch (office) or by providing cross-border services. From a legal perspective, in both cases, activities are carried out by one and the same entity with a statutory seat in an EU or EEA member state other than the host country.

Activities carried out by a subsidiary in the host country do not fall under a European passport as these activities are regulated by the authorities of the country in which the subsidiary is established. This subsidiary has its statutory seat in the host country and, as such, needs a permit from the authorities of that country (Bierman, 2016).

Host country regulation is required
Passporting is only possible for the activities under the permit and supervision of the regulatory authorities of the home country. If activities in a host country are not regulated, but a passporting institution likes to engage in these activities, it will still have to register with the host country supervisor (Bierman, 2016).

Main differences

- Bonus cap
- Leverage ratio
- Ban on inducements
- Assessment procedure

Highlighted topics and structure

In this chapter, we will discus the main differences between the legal framework of the Netherlands and other countries separately in the following order:

- Bonus cap
- Leverage ratio
- Ban on inducements
- Assessment procedure

The assessment of each topic is structured in the following order:

1. Overview of the Dutch legislative framework
2. International comparison
3. An overview of the results from the interviews
4. The potential effects of the deviations
5. Conclusions and recommendations.

Bonus cap

In the Netherlands, variable remuneration may not exceed 20% of fixed remuneration. The Dutch remuneration policy is stricter than EU-wide counterparts

The variable remuneration is capped at a maximum of 20% of the fixed salary

Regulatory framework in the Netherlands

In the Netherlands, variable remuneration is capped at a maximum of 20% of the fixed salary component. The remuneration rules in the financial sector are set out in the Act 'Wet beloningsbeleid financiële ondernemingen' (Wbfo). Wbfo applies to all financial institutions which have their offices registered in the Netherlands and all positions in the financial firm (AFM). The remuneration restriction applies to all subsidiaries and branches of a Dutch financial institution, and the branches and subsidiaries of Dutch financial institution located abroad. The remuneration restriction is not valid for branches of banks and investment firms located in the Netherlands and which are subject to Capital Requirements Regulation and Directive IV (CRD IV) legislation with a 'mother firm' located in a member state of the European Union. For instance, branches of insurance companies which do not fall under CRD IV, have to face the Dutch bonus cap.

Exemptions

Several exemptions exist related to the bonus cap (Kamerbrief 5 September 2016).

- Employees of a financial institution (on which the bonus cap is applicable) not covered by a collective labour agreement. Their variable remuneration is capped at 100% of fixed remuneration. However, the average variable remuneration of the entire group of employees may not exceed 20%.
- The bonus cap is 100% of fixed salary for employees working mainly abroad, but within the EU.
  If the employees work mainly outside the EU, the bonus is capped at 200% of the fixed remuneration.
- Managers of investment institutions or of organisations for collective investments in securities are exempt from the bonus cap of 20%. This also applies to investment firms investing for their own account and with their own resources and capital, which have no external customers.

The exemptions only apply under special conditions and with the shareholders' approval.

European directive caps the bonuses at 100% of fixed income

European regulatory framework

CRD IV includes the European policy for bonuses and caps the bonuses at 100% of fixed annual salary. With shareholder approval, bonuses up to 200% of fixed annual salary are permitted. The CRD IV bonus cap only applies to employees of banks and investment firms in Europe. The bonus cap is restricted to a specific group of employees, namely senior managers, risk management officials and staff whose professional activity involves taking risk with a material impact on the institution's risk profile.

Comparison of Dutch policy with the European directive

The bonus cap in the Netherlands is stricter than CRD IV in three ways, namely:

1. The cap is five times lower in the Netherlands.
2. The cap applies to a larger group of financial institutions.
3. The cap applies to a larger group of employees.

Remuneration policy is considerably stricter in the Netherlands than in other countries

The Dutch bonus cap seems to be extraordinarily low compared to other countries and applies to a larger group of employees

France

In France, the bonus cap is implemented according to CRD IV (Norton Rose Fulbright). France requires creating remuneration committees. The task of the committee is to review whether the remuneration under consideration does not lead to excessive risk-taking (Lexology).

United Kingdom

The UK opposes the CRD IV bonus cap. The Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have notified the European Banking Authority (EBA) that they will not comply with the part of the directive that caps the bonus at 100% of fixed remuneration or at 200% of fixed remuneration with shareholder approval. The regulators will only apply this bonus cap to large firms. Smaller institutions will not face the bonus cap set out in the CRD IV (FCA).

Germany

Germany has implemented the CRD IV directive with limited deviations. The largest deviation is the scope, which is broader than the one under the directive, just like the Netherlands. In Germany, staff members involved in performing banking business or rendering financial services are within the scope of the bonus cap. Germany does not deviate in extent the bonus cap (Norton Rose Fulbright).

Belgium

In Belgium, variable remuneration must be limited to the highest of the two following amounts: 50% of the fixed salary or €50,000. The €50,000 bonus may not exceed the fixed salary. The rules only apply to bank employees (Norton Rose Fulbright). The bonus cap in Belgium is still higher than the cap in the Netherlands and is applicable to a smaller group of employees. However, it deviates from the European standard as well.

United States

The United States seems to take a more principle-based approach than a rule-based approach on variable remuneration. The banking regulators in the United States have provided guidance regarding the variable remuneration based on the safety and soundness principles from the Federal Deposit Insurance Act (Norton Rose Fulbright). The principles state that: (1) incentive compensation arrangements at a banking organisation should provide employees with incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organisations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk-management; and (3) these arrangements should be supported by strong corporate governance, including active and effective oversight by the organisation's board of directors. (Guidance on Sound Incentive Compensation Policies). However, the United States does not enforce a bonus cap to its financial institutions.

Interview results include the effect on the business climate for young innovative firms. Interviewees indicate that the bonus cap might have a negative effect on the attractiveness of the Netherlands

Interviewees mention the bonus cap as one of the main deviations between the Netherlands and other countries

Eleven interviewees mentioned the bonus cap as one of the most notable differences between the Netherlands and other countries regarding the regulation of the financial sector.

Effects of a more restrictive remuneration regulation in the Netherlands according to the interviews

Interviewees differ in their opinion on if the bonus cap is harmful for start-ups or not
Young and innovative firms usually have largely fluctuating cash flows and usually do not have the reserves to smooth these fluctuations. Therefore, it is important for these firms to have low fixed costs. Bonuses are suitable in this case because they keep the employment fixed costs low, while providing the opportunity to offer attractive remuneration to employees (two interviews). During one interview, it was pointed out that the bonus cap in the Netherlands would harm mainly these firms. Therefore, the policy would reduce the number of new or innovative firms in the country. This point was underlined during another interview in which the interviewee mentioned that DNB has announced that it wants to change the current bonus cap for young innovative firms. The argument that a bonus cap would be harmful for young innovative firms was, however, not shared by all interview candidates. One interviewee argued that young innovative firms could easily avoid this problem by handing out shares of the firm to their employees.

Interviewees point out that the bonus cap will stimulate the reallocation of specific activities to other countries
Five interviewees mentioned the reallocation of specific activities from the Netherlands to other countries as a potential consequence of the stricter bonus policy in the Netherlands. Asset/Wealth management or trading floors were provided as examples of specific activities.

Interviewees observe that foreign banks more often choose to be present in the Netherlands using branches
During two interviews, it was indicated that the number of banks with a subsidiary in the Netherlands decreases. According to two interviewees, banks might choose to be present in the country with a branch instead of a subsidiary. This way, the bonus cap is circumvented if the branch belongs to a holding within the EU. The bonus cap is not the sole reason to open a branch instead of a subsidiary or headquarters; various factors influence this decision. However, according to three interviewees, the bonus cap is often mentioned as a disadvantage for the Netherlands.

The bonus cap has several potential effects on the labour market dynamics according to our interviewees
Moreover, interviewees stated that it would be more difficult to attract employees. In one interview, the question arose if we should find this problematic. The employees, attracted by high bonuses, might also be receptive to behaviour that has led to the financial crisis.

Interview results indicate that the bonus cap probably has a negative effect on the attractiveness of the Netherlands

One interviewee observed that the current competition between financial institutions in the labour market leads to socially undesirable outcomes. Restricting this competition by enforcing a bonus cap will, therefore, be socially desirable.

Some interviewees doubt the effectiveness of the bonus cap

Two interviewees questioned the effectiveness of the remuneration policy because it would be easy to avoid the bonus cap. The bonus cap can be circumvented by structuring the fixed remuneration in such a manner that it has the properties of variable remuneration (please refer to the box on the right for an example). According to one interviewee, circumvention requires complex constructions and, therefore, cannot be seen as an easy option.

The level playing field is disrupted according to three interviewees

According to one interviewee, the possibility to circumvent the bonus cap interferes with the level playing field in the Netherlands among financial institutions, mainly banks. Foreign institutions (mainly banks and other institutions under the restriction of CRD IV) have more possibilities to circumvent the bonus cap. This is more complicated for Dutch financial institutions (one interview). Foreign institutions can, for instance, locate their employees in the Netherlands, while keeping them on the payroll of a foreign institution. In this case, the foreign bonus cap applies. Another example mentioned in three interviews is the possibility of a foreign financial institution (under the CRD IV restriction) to open a branch in the Netherlands. In this case, the Dutch bonus cap does not apply either.

According to seven interviewees, the bonus cap reduces the relative attractiveness of the Netherlands to locate a headquarters

Five interviewees indicated that the Netherlands has become less attractive to locate a headquarters. The Brexit is mentioned as an interesting example of whether the Netherlands will be considered as a potential host country if it comes to relocating a European headquarters. According to one interviewee, Goldman Sachs was most explicit about leaving London in case of a Brexit. When asked if Amsterdam is considered, Goldman Sachs indicated that it considers Amsterdam but the bonus cap is a major disadvantage of the Netherlands.

According to one interviewee, the reputation of the Netherlands might be harmed due to the bonus cap

Lastly, one interviewee stressed that differences in financial regulation became more notable. This is the result of the harmonisation of financial regulation in developed countries and especially within Europe. Hence, the bonus cap stands out and marks the Netherlands as a strict country. Besides, the rationale of the bonus cap itself is not understood by the sector (one interview).

Box 4: Role-based allowances

New forms of remuneration have emerged to avoid the bonus cap. In the UK, for instance, 'role-based' allowances have emerged. Role-based allowances count as fixed pay, but can be adjusted upwards or downwards each year and are not pensionable (Financial Times).

The bonus cap is low in the Netherlands compared to other Western countries. Our analysis shows that the lower bonus cap could increase costs and lower flexibility, but it might also contribute to financial stability

Regulation applies to?

- All headquarters, subsidiaries and branches of banks and insurance companies with the head legal entity in the Netherlands.
- All subsidiaries of foreign banks and insurance companies in the Netherlands.
- Branches of foreign financial institutions in the Netherlands that do not fall under the restriction of CRD IV, such as insurance companies.

- Pension funds.
- Asset managers.
- Branches of banks and investment firms from CRD IV jurisdictions (= EU) in the Netherlands.
- Investment institutions and institutions for collective investment in securities. These institutions should invest their own account with their own resources and capital, and have no external customers.

Potential effects

Higher costs to attract suitable employees

We expect that financial institutions will compete in the labour market for the best employees and should provide competitive labour conditions. Accordingly, financial institutions facing a (lower) bonus cap need to raise the fixed salary if they want to offer a competitive remuneration. This can mean two things: either these financial institutions attract less suitable employees or they raise the fixed salary. However, for a given quality, a relatively higher fixed salary should be offered if the bonus cap is applicable. A higher fixed remuneration raises the labour costs as certain expenses are related to fixed but not variable remuneration, like pension contributions.

Lower flexibility and higher default risk

Bonuses can be considered as variable labour costs usually depending on the profit of the institution, among other things. Bonuses provide firms the possibility to tie the labour costs to their performance. This reduces the default risk of the firm especially if the year-to-year profits are uncertain. Thus, a higher percentage of fixed remuneration increases the risk.

Higher financial stability

Bonuses are considered to stimulate excessive risk-taking and focus on short-term profit. On an aggregated level or in case of system banks, this behaviour is believed to decrease financial stability. If this is true, a cap on bonuses will enhance financial stability (among others, Hakenes and Schnabel, 2013; Korinek and Kreamer, 2013; Johnston, 2014).

The relationship between cash bonus and risk-taking is, however, uncertain. Vallascas and Hagendorff (2013), for instance, find that increases in CEO cash bonuses may lower the default risk of a bank. Moreover, Thanassoulis (2012) argues that a stringent bonus cap leads to a shift from bonuses to fixed pay, which increases the default risk of banks. Also, a stringent bonus cap can enhance the risk-taking instead of reducing it (Vallascas and Hagendorff, 2013; Thanassoulis, 2012; Murphy, 2013).

Summary of the effect of a bonus cap on the attractiveness of the Netherlands and the competitive position of Dutch banks and insurers (effects are explained on the following pages)

Potential effects	The attractiveness to locate a headquarters in the Netherlands for a foreign financial institution	The attractiveness to locate a subsidiary in the Netherlands for a foreign financial institution	The attractiveness to locate a branch in the Netherlands for a foreign financial institution	Competitive position of Dutch financial institutions in the Dutch market	Competitive position of Dutch financial institution in the international market
Banks					
Higher costs	Negative	Negative	Positive	Negative	Negative
Lower flexibility	Negative	Negative	Positive	Negative	Negative
Higher financial stability	Positive	Positive	Positive	Neutral	Positive
Insurers					
Higher costs	Negative	Negative	Negative	Neutral	Negative
Lower flexibility	Negative	Negative	Negative	Neutral	Negative
Higher financial stability	Positive	Positive	Positive	Neutral	Positive

Positive Neutral Negative Ambiguous

Negligible Small Large

The attractiveness of the Netherlands for banks could decrease or increase. The lower bonus cap lowers flexibility and raises costs decreasing attractiveness. Attractiveness increases due to higher financial stability

Potential effects*	Headquarters		Subsidiary		Branch	
Banks						
Higher costs to attract suitable employees	🔴	• The Netherlands is less attractive as a headquarters location compared to other countries as banks operating from Dutch headquarters will have a competitive disadvantage compared to competitors in international markets. The attractiveness of the Netherlands decreases, since the higher costs might decrease profitability. • The effect is negligible because the cap can be circumvented.	🔴	• The bonus cap is applicable to all insurers active in the Netherlands. So, there is a level playing field among the banks, irrespective of the juridical form. However, the attractiveness of the Netherlands decreases, since the higher costs might decrease profitability. • The effect is negligible because the cap can be circumvented.	🟢	• The Netherlands is more attractive as a branch location compared to other countries since most of the competitors in the Netherlands must use a lower bonus cap and, hence, are confronted with higher costs. • The effect is negligible because the cap can be circumvented.
Lower flexibility and higher default risk	🔴	• Comparable to the above.	🔴	• Comparable to the above.	🟢	• Comparable to the above.
Higher financial stability	🟢	• If the cap leads to higher financial stability, this is beneficial for the attractiveness of the Netherlands (please refer to box 1). • The effect is negligible because the cap can be circumvented.	🟢	• Comparable to headquarters.	🟢	• Comparable to headquarters.

* The analysis of headquarters focuses on supply, demand and competition effects in international markets and in the Netherlands.
The analysis of subsidiaries and branches focuses only on supply, demand and competition related effects in the Netherlands.

🟢 Positive ⚪ Neutral 🔴 Negative 🟠 Ambiguous

○ Negligible ◯ Small ◯ Large

The attractiveness of the Netherlands for insurers could decrease or increase. The lower bonus cap lowers flexibility and raises costs decreasing attractiveness. Attractiveness increases due to higher financial stability

Potential effects	Headquarters		Subsidiary		Branch	
Insurers						
Higher costs to attract suitable employees	● (negative)	• The Netherlands is less attractive as a headquarters location compared to other countries as insurers operating from Dutch headquarters will have a competitive disadvantage compared to competitors in international markets. The attractiveness of the Netherlands decreases, since the higher costs might decrease profitability. • The effect is negligible because the cap can be circumvented.	● (negative)	• The bonus cap is applicable to all insurers active in the Netherlands. So, there is a level playing field among the insurers, irrespective of the juridical form. However, the attractiveness of the Netherlands decreases, since the higher costs might decrease profitability. • The effect is negligible because the cap can be circumvented.	● (negative)	• Comparable to subsidiary.
Lower flexibility and higher default risk	● (negative)	• Comparable to the above.	● (negative)	• Comparable to the above.	● (negative)	• Comparable to the above.
Higher financial stability	● (positive)	• The effect is negligible because the cap can be circumvented and bonuses might not be a large driver of instability. There is lot of discussion among experts regarding the effectiveness of the cap.	● (positive)	• Comparable to headquarters.	● (positive)	• Comparable to headquarters.

● Positive ● Neutral ● Negative ● Ambiguous ○ Negligible ○ Small ○ Large

The competitive position of Dutch banks vis-à-vis competitors is mainly negatively influenced by the lower bonus cap. The net effect, however, remains ambiguous

Potential effects		Competitive position of Dutch banks on the Dutch market		Competitive position of Dutch banks on the international markets
Banks				
Higher costs to attract suitable employees		• Dutch banks have a competitive disadvantage vis-à-vis foreign competitors operating with a European passport (please refer to box 3). Banks with a European passport can use a higher bonus cap and, therefore, have lower costs. • This effect is limited because the cap can be circumvented.		• Since the bonus cap applies to a broader scope of activities and employees than European counterparts, the competitive position of Dutch banks on international markets is negatively influenced. We assume that the higher costs in the Netherlands affect the overall profitability. • The effect is negligible because the cap can be circumvented.
Lower flexibility and higher default risk		• Comparable to the above.		• Comparable to the above.
Higher financial stability		• The competitive position of Dutch banks in the Dutch market is not influenced. All banks active on the Dutch market benefit from financial stability.		• Dutch banks have a competitive advantage if the default risk of banks is interrelated at the national level. Funding costs depend, among other things, on the default risk. Hence, in the case of interrelated default risk, the funding costs of banks are lower in a country with a stable financial system because in a country with a stable financial system, the default risk of a bank is expected to be lower. • The effect is negligible because the cap can be circumvented and bonuses might not be a large driver of instability.

Positive Neutral Negative Ambiguous Negligible Small Large

The competitive position of Dutch insurers vis-à-vis competitors is mainly negatively influenced by the lower bonus cap. The net effect, however, remains ambiguous

Potential effects	Competitive position of Dutch insurers on the Dutch market	Competitive position of Dutch insurers on the international markets
Insurers		
Higher costs to attract suitable employees	• The competitive position of Dutch insurers on the Dutch market is not influenced because the bonus cap is applicable to all insurers active on the Dutch market.	• In the international market, most competitors of the Dutch institutions have a less restrictive bonus cap. All subsidiaries and branches of Dutch insurers are confronted with the broader scope of the Dutch bonus cap. Therefore, Dutch insurers operating on the international market have a competitive disadvantage compared to foreign insurers. • This effect is limited because the cap can be circumvented.
Lower flexibility and higher default risk	• Comparable to the above.	• Comparable to the above.
Higher financial stability	• The competitive position of Dutch insurers on the Dutch market is not influenced. All insurers active on the Dutch market benefit from financial stability.	• Dutch insurers have a competitive advantage if the default risk of insurers is interrelated at the national level. Funding costs depend, among others, on the default risk. Hence, in case of interrelated default risk, the funding costs of insurers are lower in a country with a stable financial system because in a country with a stable financial system, the default risk of an insurer is expected to be lower. • The effect is negligible because the cap can be circumvented and bonuses might not be a large driver of instability.

Positive Neutral Negative Ambiguous Negligible Small Large

Bonus cap: conclusions and recommendations

Conclusions

Dutch financial regulation in comparison to other countries

The Netherlands has a bonus cap of 20% of fixed remuneration, while in other EU countries, a cap of 100% of fixed remuneration is used.

Attractiveness of the Netherlands

- For banks: the effect of more stringent bonus regulations is ambiguous in case of presence in the form of headquarters and subsidiaries. The bonus cap enhances the attractiveness of the Netherlands for establishing bank branches.
- For insurers: The effect is ambiguous for all types of entry.

Competitive position in the Netherlands

- The cap distorts competition among banks on the Dutch market, as foreign banks with a passport can use a higher bonus cap, and as a result have lower costs.
- Insurers compete on equal terms, as all competitors face the same bonus cap. The effect is neutral.

Competitive position of Dutch institutions abroad

- The competitive strength of Dutch banks and insurers in international markets is ambiguous. Most competitors will face a less restrictive bonus cap. However, Dutch institutions may benefit from more financial stability.

Off-setting factors for the effects of the deviation

- The bonus regulation in the Netherlands can be circumvented.
- Regulating bonuses is unlikely to contribute significantly to financial stability.

Recommendations

- The current bonus cap in the Netherlands should at least be aligned with the one used in the rest of the EU.

Leverage ratio

Setting a minimum leverage ratio for banks is expected to increase solvability, contributing to a resilient banking system and a healthier economy

A minimum leverage ratio for banks is required to increase the solvability of banks

Financial crisis

In the past, financial crises demonstrated that banks without a sufficient amount of reserves in the form of equity can fail as declining asset values erode their solvability. Insufficiently capitalised banks may further have difficulty acquiring funding as they are perceived more risky, leading to liquidity problems.

Financial instability as a result of weakened banks can result in a decline in trust, investments, economic growth and employment. As such, it is in the interest of society that financial institutions have sufficient reserves to overcome adverse conditions.

In the aftermath of the global financial crisis, authorities in Europe, America and Asia strived to develop rules in common to enhance the solvability of banks and, as such, the resilience against new headwinds. Through the Basel Committee on Banking Supervision, a number of countries developed a new reformed framework commonly referred to as 'Basel III'.

Capital Requirement Directive

In Europe, capital requirements for banks are defined in the Capital Requirement Directive (CRD) of the European Commission. CRD IV is the latest version of this directive and consists of the Capital Requirements Directive (Directive 2013/36/EU) and the Capital Requirements Regulation (Regulation EU No 575/2013). Both represent the legislative implementation of Basel III in the EU and need to be embedded in national law. CRD IV is effective from 1 January 2014.

In the Netherlands, CRD IV is predominantly implemented via the 'Wet op het financieel toezicht' (Wft). Within the CRD IV framework, a minimum leverage ratio for banks is stipulated. The leverage ratio's main objective is to 'prevent damage to the financial system and the economy by containing build-ups of leverage in the banking sector that could ultimately result in destabilizing deleveraging spirals (BIS, 2015).

Leverage ratio

The leverage ratio is defined as the ratio of Tier 1 capital (numerator) and an exposure measure (denominator). The latter is equal to the sum of the following items: on-balance sheet exposures (i.e. all balance sheet items such as loans), derivatives exposures, exposures from securities financing transactions and off-balance sheet items.

Regulatory framework in the Netherlands

Currently, the minimum leverage ratio in the CRD IV framework is 3%. However, the Dutch government aspires for a higher ratio of 4% for system relevant banks[1] (after failing to secure this ratio on a European level) (Mvt - Implementatiewet richtlijn en verordening kapitaalvereisten, page 8; NVB). Any final adjustments to the definition and calibration of the leverage ratio will, however, be made by the end of 2017 (BIS). The Dutch government may still hope that the leverage ratio will be set higher for all CRD IV jurisdictions. It is very likely that the ratio will remain 3% as currently proposed.

1 System relevant banks are institutions perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope. (BIS)

In Europe, only the Netherlands, the UK and Switzerland use a higher minimum leverage ratio

The leverage ratio is risk neutral

The leverage ratio reflects the amount of shareholder capital available to absorb losses (capital measure or equity) divided by the total value of assets (the exposure measure, off- and on-balance sheet).

The leverage ratio does not consider the riskiness of assets. It only includes the total asset value. The omission of asset risk is beneficial as certain assets may be deemed safe at one point, but turn out to be poisonous at another. During the financial crisis, this was observed in the case of structured mortgage loans.

Combination of ratios

The leverage ratio is not meant to be a stand-alone measure. Within the CRD IV framework, it is used along with the Common Equity Tier 1 (CET1) ratio and the Liquidity Coverage Ratio (LCR). CET1 considers the risk of assets via the Risk-Weighted Assets measure. The purpose of LCR is to ensure a bank has enough assets at hand that can quickly and easily be converted to cash, to cover short-term obligations. The combination of these three ratios with their minimum levels aims to improve the resilience of banks during tough times.

For some banks, a higher leverage ratio may be attained easily, but if this is the case with more risky assets, it should have a negative impact on the CET1 ratio. This should be considered when only leverage ratios are compared (internationally).

The leverage ratio that the politicians and DNB are aspiring for in the Netherlands and the leverage ratio in the UK, are high compared to other European countries. The US and Switzerland apply a higher required leverage ratio than the Netherlands

European context

CRD IV applies to the European Union and all member state banks are required to maintain a minimum leverage ratio of 3%. The Netherlands and the UK are exceptions as these countries enforce a higher minimum leverage ratio for large or system banks. In the Netherlands, this is set at 4%, but it is currently not a legal requirement. In the UK, a minimum leverage ratio of 3% is legally required, to which 35% of the systemic buffer and 35% of the counter-cyclical buffer of banks is added (Bank of England, 2015). Outside the EU, Switzerland stipulates a minimum leverage ratio of 5% for systemic banks (FINMA).

United States

The US enforces a minimum leverage ratio of 4% and 5% for system relevant banks. Insured depository institution subsidiaries of these system relevant banks are even required to maintain a minimum leverage ratio of 6% (Shearman, 2013). US banks have until 1 January 2018 to achieve these ratios (PwC, 2014).

In interviews, the higher leverage ratio is identified as a deviation, but its impact is not assumed to be significant

In interviews, the higher required leverage ratio in the Netherlands is frequently mentioned as a significant difference

In interviews, the minimum leverage ratio of 4% is mentioned six times out of 22 as one of the more significant deviations from other countries.

In four cases, this minimum level is put in context by referring to higher actual leverage ratios of banks abroad. According to two persons, the lower Dutch leverage ratio relates to the relatively high quality of the assets (such as mortgage loans). This helped banks maintain less equity against potential losses. One interviewee indicated that the higher leverage ratios of banks in other European countries is due to market forces, but two others stated that markets are not segregated as long as pressure to increase ratios is (much) higher in one European country than in another.

None of the people interviewed indicated that raising the minimum leverage ratio from 3% to 4% would have significant impact, apart from adjustment costs in the short term

Four interviewees stated that a leverage ratio of even 4% is relatively low in an international context and suggested that Dutch banks would have to raise their leverage ratios (far) above 3% anyway to meet the levels in other developed countries. One commented that 3% is not a serious minimum level anymore in Europe and elsewhere. Two interviewees argued that capital ratios should be raised by forced equity issuance (as in the US). One interviewee commented that raising new equity can be costly for banks in the short term, especially if this is not obligatory for multiple banks. However, banks earlier enjoyed advantages in the form of government guarantees and lenient regulation. Raising capital would just be a reversal of these former benefits.

Box 5: The Modigliani-Miller theorem does not hold for banks, making debt funding more attractive than equity funding

Debt financing is advantageous especially for banks
In making a choice between the use of debt and equity for capital, banks have a stronger inclination to choose the former. The Modigliani and Miller (MM) theory provides an explanatory framework for this preference.

Modigliani and Miller
The MM theory states that the way a firm is financed does not affect its value. This is because there is a trade-off between debt and equity financing.

Debt financing is generally cheaper than equity financing as cash flows for debt providers are more certain. However, if the relative amount of debt increases, the default risk rises.

A resulting higher risk profile increases the funding costs of debt as well as equity, as providers of capital demand a higher risk premium. According to the theorem, these two effects are equal; so a change in the financing structure does not affect the weighted average cost of capital (WACC) of the firm (Hillier, Grinblatt and Titman, 2008).

Tax shield
The theorem does not hold, because profits of a firm are taxed with the corporate income tax. Interest on its debt, however, is deductible from profit, while the return on equity is not (capital gains and dividends). So, the WACC can be reduced by increasing the relative amount of debt in the firm (Hillier, Grinblatt and Titman, 2008).

Deposit Guarantee Scheme
Deposit insurance is another reason why the MM theorem does not hold and why it is profitable for banks to use more leverage. Deposits are funding or a way of debt financing for banks. As deposit holders do not completely bear the risk of the bank's bankruptcy due to insurance, the interest on deposits is not (or not enough) influenced by the risk profile of the banks (Demirgüç-Kunt and Huizinga, 2004).

Too big to fail
System relevant banks have an additional motive to use debt financing. This is the implicit 'too big to fail' guarantee. An expected bail-out by the government will lower the risk and, hence, borrowing costs. An increase in the relative amount of debt lowers the WACC, making it advantageous to increase the leverage (Bijlsma and Mocking, 2013).

Stricter capital requirements in the Netherlands increase the funding cost of system relevant banks
Because of the above three reasons, the MM theory does not hold for banks. An increase in the leverage ratio from 3% to 4% raises the funding costs of banks because a higher required equity component leaves less opportunity to use lower costs for debt funding either by means of deposits (assets) or loans.

5

In the Netherlands, the leverage ratio for systemic banks is high compared to peers in most other EU countries. A higher leverage ratio can signal strength, increase funding costs and enhance financial stability

Regulation applies to?

- Banks, system relevant for the Netherlands, using a Dutch banking permit.

- Banks with a Dutch banking permit which are not system relevant.
- Branches or representative offices of banks from EU or EEA member states.

Potential effects

Higher funding costs
A higher leverage ratio reduces the ability to use debt to lower the funding cost. The Modigliani-Miller theorem does not hold for banks; so higher equity requirements raise the funding costs (please refer to box 5).

Strength signal
Banks with a higher leverage ratio are perceived to be more robust and are expected to have a lower risk, because banks with a larger equity buffer are better suited to withstand a decline in the value of their assets.

Higher financial stability
The robustness of system relevant banks contributes to financial stability. The leverage ratio in turn contributes to the robustness of system relevant banks and as such to the system stability of the financial sector in the Netherlands.

Summary of the effects of a higher leverage ratio on the attractiveness of the Netherlands and the competitive position of Dutch banks (in the following pages, we explain the effects)

Potential effects	The attractiveness of locating a headquarters in the Netherlands for a foreign bank	The attractiveness of locating a subsidiary in the Netherlands for a foreign bank	The attractiveness of locating a branch in the Netherlands for a foreign bank	Competitive position of Dutch bank in the Dutch market	Competitive position of Dutch bank in the international market
System relevant banks					
Funding costs	Negative, Negligible	Negative, Negligible	Positive, Negligible	Negative, Small	Negative, Negligible
Strength signal	Positive, Negligible	Positive, Negligible	Negative, Negligible	Positive, Small	Positive, Negligible
Financial stability	Positive, Small	Positive, Small	Positive, Small	Neutral, Small	Positive, Small
Non-system relevant banks					
Funding costs	Positive, Negligible	Positive, Small	Positive, Small	Positive, Small	Neutral, Small
Strength signal	Negative, Negligible	Negative, Small	Negative, Small	Negative, Small	Neutral, Small
Financial stability	Positive, Small	Positive, Small	Positive, Small	Neutral, Small	Positive, Small

Positive Neutral Negative Ambiguous Negligible Small Large

System banks – The effect of higher funding costs due to higher required leverage depends on the type of market entry

Potential effects	Headquarters		Subsidiary		Branch	
Higher funding costs	● (Negative)	• Based on the assumption that funding costs abroad are influenced by funding costs in the Netherlands, we conclude that the Netherlands becomes less attractive for locating headquarters. Higher funding costs are competitive disadvantage vis-à-vis competitors abroad. Higher costs are also a disadvantage in the Netherlands since non-system relevant banks are not subject to the higher leverage requirement. The attractiveness also decreases, because higher costs might decrease profitability • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.	● (Negative)	• In the unlikely scenario that a subsidiary would be considered system relevant, the effect on the attractiveness of the Netherlands would be negative. The subsidiary would face a competitive disadvantage with respect to non-system banks and branches of foreign banks which have a system relevant status. The attractiveness also decreases, because higher costs might decrease profitability. • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.	● (Positive)	• In the unlikely scenario that a branch would be considered system relevant, the effect on the attractiveness of the Netherlands would be positive. The branch would face a competitive advantage with respect to system banks which are subject to the requirements. • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.

● Positive ● Neutral ● Negative ● Ambiguous ○ Negligible ○ Small ○ Large

System banks – The effect of the strength signal due to the higher required leverage depends on the type of market entry

Potential effects	Headquarters		Subsidiary		Branch	
Strength signal	Positive	• The Netherlands is more attractive as a headquarters location than other countries. System relevant banks operating from Dutch headquarters would have a competitive advantage over competitors in the international markets because they would appear more solid. The system relevant banks have a competitive advantage vis-à-vis local competitors not subject to the 4% leverage ratio. • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.	Positive	• The Netherlands is more attractive as location for subsidiaries due to the increased strength signal vis-à-vis local competitors not subject to the 4% leverage ratio. • This effect is negligible.	Negative	• In most cases, the branch will fall under the supervisor of another European country (assuming they will use a passport). So the home country minimum leverage ratio requirement of 3% will apply. Some of the main competitors in the Dutch market will be obliged to have a 4% leverage ratio which provide them with a competitive advantage as they signal strength. • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.

Positive Neutral Negative Ambiguous

Negligible Small Large

Non-system banks – The effect of higher leverage ratio for system relevant banks in the Netherlands, on the attractiveness of the Netherlands is ambiguous and depends on the type of market entry

Potential effects	Headquarters	Subsidiary	Branch
Higher funding costs	• Since the requirement does not apply to non-system banks, it does not affect the competitiveness on foreign markets (please refer to Box 5). On the Dutch market non-system relevant banks have a competitive advantage with respect to system banks. The non-system banks have relative lower funding costs. • The effect is negligible small.	• The Netherlands is more attractive as a subsidiary location than other countries since the main competitors in the Netherlands experience either higher funding costs if they are system relevant or comparable funding costs if they are not system relevant. Thus, the foreign subsidiary has a competitive advantage over the system relevant banks on the Dutch market (please refer to Box 5).	• Comparable to subsidiary.
Strength signal	• Since the requirement does not apply to non-system banks, it does not affect the competitiveness on foreign markets (please refer to Box 5). On the Dutch market non-system relevant banks have a competitive disadvantage with respect to system banks. The non-system banks will not appear more solid. • This effect is negligible. Even though foreign banks are not required to have a leverage ratio of 4%, many foreign banks actually have a leverage ratio higher than 4%.	• The Netherlands would be less attractive as a subsidiary location than other countries since the main competitors in the Netherlands have competitive advantage because they would appear more solid.	• Comparable to subsidiary.

Positive Neutral Negative Ambiguous Negligible Small Large

Higher financial stability increases the relative attractiveness of the Netherlands for foreign banks considered system or non-system relevant

Potential effects		Headquarters		Subsidiary		Branch
Higher financial stability	●	• Increased stability of the sector is conducive to attractiveness (please refer to Box 1). The attractiveness of the Netherlands increases as a consequence.	●	• Comparable to headquarters.	●	• Comparable to headquarters.

● Positive ● Neutral ● Negative ● Ambiguous ○ Negligible ○ Small ○ Large

The effect on the competitive position of Dutch system relevant banks vis-à-vis its competitors is ambiguous

Potential effects	Competitive position of Dutch system relevant banks in the Dutch market	Competitive position of Dutch system relevant banks in the international markets
Higher funding costs	• Previously, (Dutch) system relevant banks had a competitive advantage over (Dutch) non-system banks in the Dutch market. The system relevant banks were able to raise funds at a lower price because of the too-big-to-fail discount. Due to the leverage ratio, this advantage has decreased. • The competitive position of Dutch system banks compared to foreign (system) banks (that are not treated as system banks on the Dutch market or are not active using a Dutch permit) on the Dutch market has decreased. The funding costs of the Dutch banks has increased, while the funding costs of the competitors remained unchanged. • This effect is small because a large part of main competitors are either system relevant in the Netherlands or retain a higher leverage ratio than the minimum required leverage ratio for system relevant banks in the Netherlands.	• The competitive position of Dutch system banks compared to foreign (system) banks on the international market has decreased. The funding costs of the Dutch banks has increased, while the funding costs of the competitors remained unchanged. • This effect is negligible because most competitors retain a higher leverage ratio than the minimum required leverage ratio for system relevant banks in the Netherlands (please refer to Appendix 3).
Strength signal	• The competitive position of Dutch system banks compared to non-system banks on the Dutch market has improved because they appear more robust as a result of the higher leverage ratio. • This effect is small, because most of the main competitors are either system relevant in the Netherlands or retain a higher leverage ratio than the minimum required leverage ratio for system relevant banks in the Netherlands.	• The competitive position of Dutch system banks compared to banks on the international markets has improved because they appear more solid as a result of the higher leverage ratio. • This effect is negligible, because most main competitors retain a higher leverage ratio than the minimum required leverage ratio (please refer to Appendix 3).
Higher financial stability	• The competitive position of Dutch system banks on the Dutch market is not influenced. All banks active on the Dutch market benefit from the financial stability.	• Dutch banks have a competitive advantage if the default risk of banks is interrelated at national level. In this case, the funding costs of banks are lower in a country with a stable financial system.

Positive Neutral Negative Ambiguous Negligible Small Large

The competitive position of Dutch non-system relevant banks vis-à-vis Dutch competitors is ambiguous, and they enjoy an international advantage

Potential effects	Competitive position of Dutch non-system relevant banks in the Dutch market	Competitive position of Dutch non-system relevant banks in the international markets
Higher funding costs	• Previously, (Dutch) system relevant banks had a competitive advantage over (Dutch) non-system banks in the Dutch market. The system relevant banks were able to raise funds at a lower price because of the too-big-to-fail discount. The leverage ratio corrects for this competitive advantage by raising the funding costs of the system relevant banks. Thereby, the leverage ratio increases the competitive position of non-system relevant banks compared to system relevant banks as the funding costs of the system relevant banks has increased because of the higher leverage ratio while the funding costs of the non-system relevant banks remains unchanged.	• Since the higher leverage ratio does not apply to non-system relevant Dutch banks, their competitiveness in foreign markets remains unchanged.
Strength signal	• The competitive position of Dutch non-system banks in the Dutch market is negatively influenced as the system relevant banks on the Dutch market would appear more solid.	• Comparable to the above.
Higher financial stability	• The competitive position of Dutch system banks in the Dutch market is not influenced. All banks active on the Dutch market benefit from the financial stability.	• Dutch banks have a competitive advantage if the default risk of banks is interrelated at national level. In this case, the funding costs of banks are lower in a country with a stable financial system.

Positive Neutral Negative Ambiguous Negligible Small Large

Leverage ratio: conclusions and recommendations

Conclusions

Dutch financial regulation in comparison to other countries

The minimum leverage ratio of 4% for system relevant banks in the Netherlands is relatively high compared to the majority of the EU member states, where a minimum of 3% is used. This minimum leverage ratio of 4% is not a current legal requirement.

Attractiveness of the Netherlands

- System relevant banks: attractiveness is ambiguous for all three forms of market entry.
- Non-system relevant banks: in case of headquarters, the Netherlands can be attractive due to higher financial stability, outweighing funding costs and strength signal. In case of the other two entry forms, the result is ambiguous.

Competitive position in the Netherlands

- System relevant banks: the effects on competitiveness are ambiguous.
- Non-system relevant banks: the effects are ambiguous.

Competitive position of Dutch institutions abroad

- System relevant banks: the effects on competitiveness are ambiguous.
- Non-system relevant banks: enjoy an advantage, as they can benefit of lower funding costs due to greater financial stability in the Netherlands as a whole, and the higher leverage ratio does not apply to non-system banks.

Off-setting factors for the effects of the deviation

- Foreign banks tend to have equal or higher leverage ratios than the minimum required ratio in the Netherlands.
- Funding costs of banks are lower in a country with a stable financial system, if the default risk of banks is interrelated at national level.

Recommendations

- In the future, the Dutch government could consider introducing a higher leverage ratio by law.
- The leverage ratio of 4% is, according to many economists and other academics, still comparatively low. This ratio should be raised to a level that academics generally agree upon at which financial distress of a bank is unlikely, and can be avoided. The higher the leverage ratio, the lesser the need for other regulation.
- It is more desirable to establish higher leverage ratio requirements, on at least an EU-wide level, to prevent regulatory arbitrage and create a level playing field.

Inducements

The Netherlands introduced a broader prohibition of inducements at an earlier stage compared to other EU member states

In the Netherlands inducements are prohibited

Reason of the ban of inducements

Inducements, also known as commissions or provisions, are payments to distributors or advisers in exchange for the sale of a financial product. As laid out in legislation, the underlying principle for prohibiting inducements is that investment service providers must act in the best interests of their clients. When a financial institution receives inducements from a third party in exchange for services or products provided to a client, a conflict of interest could arise. The institution might be inclined to raise its commission income instead of providing advice aligned with its customers' best interest and circumstances.

Political context in the Netherlands

In 2009, the Netherlands extended the MiFID inducement rules to complex financial products and mortgage loans, while this was not a MiFID requirement (Labeur, 2014). In 2011, the Dutch Minister of Finance argued for a complete ban on inducements at EU level, but Europe did not opt for such a ban. The Netherlands then decided to proceed independently. In January 2013, the Dutch government introduced a national prohibition of inducements for all investment institutions.

Regulatory framework

The prohibition for inducements in Dutch law is included in article 168a of 'Besluit gedragstoezicht financiële ondernemingen' (Bgfo). In this article, inducements are defined as any form of reward or compensation for financial or related services provided to retail investors.

Financial institutions are allowed to receive rewards or compensation for independent investment advice or asset management services, but only directly from clients. The ban on inducements will be evaluated by the Dutch government and market participants in 2017.

Scope

The prohibition applies to all financial institutions active on the Dutch market, even if such an institution is active with a European passport. The only exception are EEA investment institutions that provide services with a European passport and from offices located in the Netherlands (Labeur, 2014).

The ban is less restrictive in other EU countries

European regulatory framework

The Markets in Financial Instruments Directive (MiFID), in force since November 2007 and applicable to all EU member states, is a directive that governs the provision of investment services in financial instruments by banks and investment firms, as well as the operations of traditional stock exchanges and alternative trading venues. Since November 2007, MiFID is incorporated in Dutch law in the 'Wet op het financieel toezicht' (Wft).

Article 26 of MiFID (Directive 2006/73/EC) allows the reception of inducements, on condition that an investment service provider discloses to clients details about the nature of such an arrangement with third parties. In addition, a commission received must enhance the quality of the service provided to the client and should not impair the duty to act in the client's best interests.

The UK and the Netherlands are considered to have the most strict regimes within Europe

The latest revision of this directive, known as MiFID II (Directive 2014/65/EU), stipulates that inducements are not allowed in case of independent advice and discretionary asset management services, unless passed on in full to the client. However, in case of other types of investment services, inducements are still allowed under the conditions previously mentioned in relation to Article 26 (MiFID II needs to be incorporated in national law as of 3 July 2017 and will be effective as of 3 January 2018 - AFM).

Differences with the Netherlands

Compared to MiFID II, the Dutch prohibition of inducements applies to more types of financial services (investment and savings products, mortgages and several insurance products) and applies to all distribution forms, i.e. not only independent advisers.

In Europe, the UK and the Netherlands have the strictest regimes regarding inducements

Deviations from MiFID

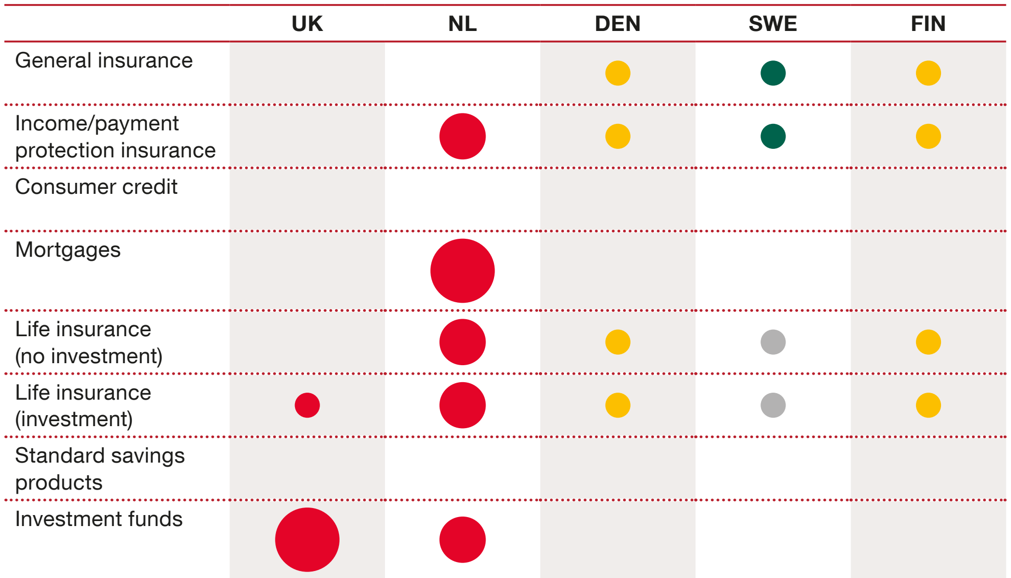
In addition to the Netherlands, the UK and the Nordic countries also deviate from MiFID II (PwC). Denmark, Finland and, more recently Sweden, have bans on commissions for independent insurance brokers. The scope and impact of this ban in the Nordic countries is considered limited (Oxera, 2015). Please see the table on the right.

The UK and the Netherlands

The Netherlands and the UK (as stipulated in the Retail Distribution Review or RDR) use stricter rules than MiFID II in terms of scope. In the UK, the ban on inducements was effective from 1 January 2013 (Oxera, 2015).

This ban is applicable for retail investment products, including pension policies, investment trusts, savings schemes, securities, equities and structured capital-at-risk products, i.e. insurance, pension products and mortgages are not included. As such, it is more limited in scope than the Dutch regime.

Scope of inducement restrictions by country and product



Note: The size of the bubble indicates the relative scale of the distribution sector affected by the regulation.

All distributors; Independant brokers, mainly with business clients; Industry self-regulation of brokers; Proposed regulation

Source: Oxera, 'Regulating remuneration systems: effective distribution of financial products' 2015, page 38.

Four interviewees mention the ban on inducements as a Dutch deviation from the European standard. Our interviewees considered the impact of the ban to be small

In four interviews, the ban on inducements is mentioned as an important difference in regulation between the Netherlands and other countries

During four interviews, the Dutch ban is specifically mentioned as a significant deviation. The interviews confirmed that the Netherlands and the UK have a more strict regime. One interviewee considers the ban to be unavoidable in the European context.

Justification of the ban

One interviewee indicates that the origin of the ban was scandals such as the 'woekerpolissen' case, in which very high fees were charged for investment-based insurance policies. None of the interviewees with whom we discussed the ban questioned its justification. All of them acknowledged that the prohibition of inducements had benefits outweighing disadvantages.

Interviews indicate that the ultimate impact of the ban on inducements is neutral for the competitive position as well as the attractiveness of the Netherlands

As the ban is valid for all financial service providers in the Netherlands and for similar products, a level playing field is created for both Dutch and foreign entities. Two interviewees think that the ban can be a reason for financial institutions to not the enter the Dutch market, or leave it. However, they also expect that the ban as a single factor is unlikely to have this effect. In addition, the likeliness of EU-wide harmonisation of a ban on provisions is seen as a neutralising factor, that will create a more level playing field in the region.

'Execution only' services

According to two interviewees, more retail clients opt for 'execution only' services instead of financial advice, due to higher fees for the latter. One interviewee commented that the impact of the ban is difficult to assess, but suggests it may have led to less diversification of services and products provided, as inducements could not be used for promotional purposes anymore.

Higher costs

One interviewee indicated that due to the ban on provisions, investment products needed to be amended to reflect costs excluding inducements paid to distributors. As a result, fund products, or more specifically share classes, with fees excluding inducements need to be created. Obviously, the creation and maintenance of these new share classes is not without any costs. For example, investment management companies that offer mutual funds in the Netherlands and abroad may need a provision-free share class for the Netherlands, and a share class with provisions for foreign markets. This is less efficient than having one share class for all markets.

Increased transparency and protection of customer interests

According to four interviewees, the positive effects of the ban on inducements will outweigh the negative effects. The interviewees emphasise the importance of increased transparency and protection of customer interests triggered by the ban on inducements.

Interviewees state that the ban on inducements can have an effect on the retail channel, though it is possible to circumvent the prohibition

Distribution channel

Inducements are an important element in the distribution channel of financial products. According to one interviewee, the suppliers of financial products and services use inducements to draw special attention to their products, helping them to set up or maintain a distribution network. One interviewee argued that this is especially important when a new provider enters the market, because inducements are used to establish brand or product awareness. The ban on inducements will therefore be an impediment to their market entry, according to the interviewee.

Circumvention

The ban on inducements is not a big issue according to one interviewee, partly because this can be circumvented with structures such as multi-asset funds (please see the box on the right). According to this interviewee, the AFM lacks sufficient knowledge of financial products to assess such circumventions.

Evaluation in 2017

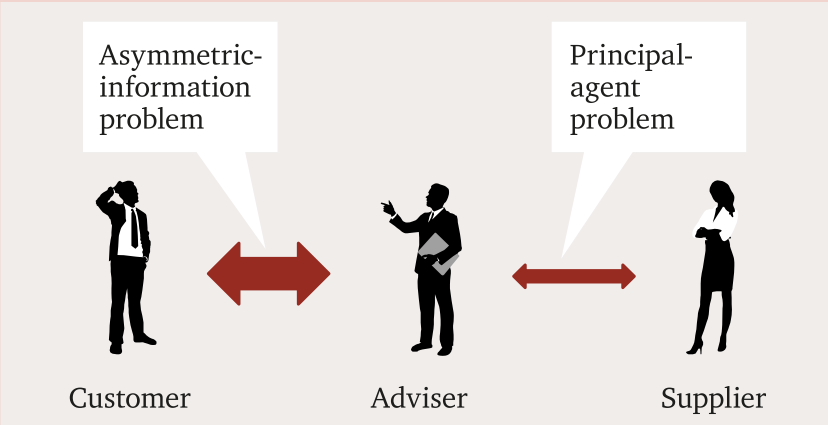
One interviewee pointed out that an evaluation of the Dutch ban in 2017 by the government and market participants will make the effects clearer.

Box 6: Obscuring costs

In the Netherlands, banks are important providers of financial advice. According to a Schroders survey (Beleggingsbarometer 2015, page 24), more than 30% of respondents used banks for financial advice. The second place is taken by independent asset managers with a share of 9% (as an aside, 55% of respondents do not use professional financial advice, in 2014 this was 52% and this is indicative of the growth of the 'execution-only' channel). Due to their position as financial advisers, banks were more strongly impacted by the prohibition of inducements, and more strongly incentivised to compensate this source of income. A way in which compensation can be realised is by creating umbrella-funds or 'mandate funds'. These investment vehicles consist of several layers of investment funds (from third parties), among which institutional fund classes that normally charge relatively low fees due to advantages of scale. These funds are combined into one product, often with a label provided by the financial institution or bank in this case, making it an 'in-house product'. For this product, a fee, such as management fee, is charged. Due to the layered structure, it is however unclear how much of the fees of the underlying investment funds are represented in the management fee of the umbrella-fund. It is argued that the management fee is kept higher than required to compensate for the loss of income in the form of inducements.

Box 7: Inducements can be used to reduce the principal-agent problem, but shift the asymmetric-information problem from between supplier and adviser to customer and adviser

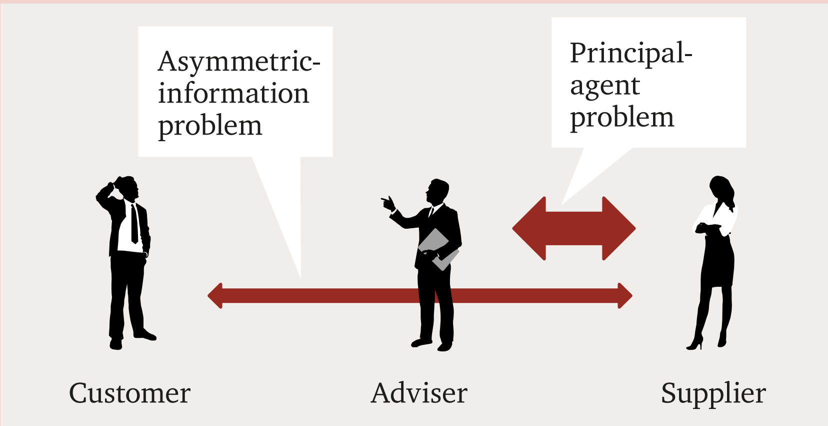
Situation with inducements



Comments

- Inducements can reduce the principal-agent problem (right column) by aligning the incentives of the adviser with the interest of the supplier.
- Inducements do not solve the asymmetric-information (right column) problem between the supplier and customer, but shift the problem to an asymmetric-information problem between the customer and adviser.

Situation with a ban on inducements



Comments

- With a ban on inducements, the principal-agent problem revives between advisers and suppliers.
- A ban on inducements reduces the asymmetric-information problem between the adviser and customer due to increased transparency, the adviser can reduce the asymmetric-information problem between the customer and supplier.

Comments

- **A principal-agent problem** between the adviser and supplier of financial products might exist. The adviser needs to invest time in new products to assess them, therefore he/she would like to minimise the changes in and the amount of products he/she offers. The financial suppliers want the adviser to promote their (new) products (please refer to Motta p. 302-410 and Tirole for an elaborate discussion on vertical agreements and perfect contracting).
- **Asymmetric-information problem:** the problem arises when the consumers have difficulty assessing the quality of products.

The Dutch ban on inducements applies to a broader range of products and services. This has an effect on the demand for financial advice, efficiency and competition among providers

Regulation applies to?

- Advisers and intermediaries for complex financial products, including financial service providers such as banks, insurers and investment advisers.

- Advice and intermediary services for professionals or institutional investors.
- Financial services in which all fees are received directly from clients and not third parties.

Potential effects (1)

The demand for financial advice might diminish due to perceived costs

The ban on inducements changes the business model of financial advisers. Previously consumers did not have to pay directly for financial advice. Since the ban on inducements financial advisers charge customers a fee for their service. Not all customers are willing to pay these fees since they perceive these payments as 'new' costs.

The demand for (certain) financial products might diminish

An eventual decline in the demand for financial advice would result in a decline in the demand for (certain) financial products. Financial advice can reduce asymmetric information and thus increase the demand for financial products. This is especially the case for complex products. The demand for financial products might also decrease if the ban leads to inefficiencies in the distribution of financial products. Inefficiencies might arise due to the decreased ability of providers to use inducements to align the interest of the advisers with their incentives. As noted above, inducements can be used by solving the principal-agent problem.

The level of competition between providers of financial products can change

The ban affects competition among providers. It could reduce the efficiency of the retail distribution channel and thereby reduce competition. It could also increase competition by increasing the transparency of the relative distribution costs of competing providers.

a) Efficiency of the distribution channel
Inducements can be used to decrease inefficiency arising from the principal-agent problem. Inducements can provide an incentive for the financial advisers to increase the effort to sell certain financial products (please refer to Box 7).

b) Transparency of fees and comparability
The ban on inducements could increase the transparency of the (relative) distribution costs of providers. This in turn can lead to increased competition.

The ban on inducements can benefit trust as well as stability

Regulation applies to?

- Advisers and intermediaries for complex financial products, including financial service providers such as banks, insurers and investment advisers.

- Advice and intermediary services for professionals or institutional investors.
- Financial services in which all fees are received directly from clients and not third parties.

Potential effects (2)

Enhance trust in the financial sector
The ban of inducements could enhance the trust in the financial sector.

Contribute to financial stability
The ban on inducements could induce financial advisers to take better account of the potential (solvency) risk of consumers. This in turn can contribute to an improvement in the 'balance sheets' of households resulting in positive effects for financial stability.

Summary of the effects of a more elaborate ban on inducements on the attractiveness of the Netherlands, and the competitive position of suppliers of financial products

Potential effects	The attractiveness to locate a headquarters in the Netherlands for a foreign fin. inst.	The attractiveness to locate a subsidiary in the Netherlands for a foreign fin. inst.	The attractiveness to locate a branch in the Netherlands for a foreign fin. inst.	Competitive position of suppliers on the Dutch market	Competitive position of suppliers on the international market
Suppliers of financial products					
The demand for (certain) financial products diminishes	Negative, Negligible	Negative, Negligible	Negative, Negligible	Neutral, Small	Neutral, Small
Competition among suppliers of financial products changes	Negative, Negligible	Negative, Small	Negative, Small	Neutral, Small	Neutral, Small
The trust in the financial sector is enhanced	Positive, Negligible	Positive, Small	Positive, Small	Neutral, Small	Neutral, Small
Financial stability increases	Positive, Negligible	Positive, Negligible	Positive, Negligible	Neutral, Small	Positive, Negligible

Positive Neutral Negative Ambiguous   Negligible Small Large

Summary of the effects of a more elaborate ban on inducements on the attractiveness of the Netherlands and the competitive position of financial advisers (on the following pages, we explain the effects)

Potential effects	The attractiveness to locate a headquarters in the Netherlands for a foreign fin. inst.	The attractiveness to locate a subsidiary in the Netherlands for a foreign fin. inst.	The attractiveness to locate a branch in the Netherlands for a foreign fin. inst.	Competitive position of advisers on the Dutch market	Competitive position of Dutch advisers on the international market
Financial advisers					
The demand for financial advice diminishes					
The trust in the financial sector is enhanced					
Financial stability increases					

Positive Neutral Negative Ambiguous Negligible Small Large

Reduced demand for (certain) financial products as a result of the ban on inducements, reduces the attractiveness of the Netherlands for suppliers of financial products

Potential effects		Headquarters		Subsidiary		Branch
Suppliers of financial products						
The demand for (certain) financial products diminishes	●	• The ban on inducements reduces the attractiveness of the Netherlands for suppliers of financial products to establish local presence as the demand for certain financial products diminishes. Since all of the financial product suppliers are subject to the ban, the ban on inducements does not affect the competitive situation in the Netherlands. As the ban only applies to activities in the Dutch market, the international competitive position is not affected. • We expect this effect to be negligible under the following assumptions: the demand for simple products is less dependent on the intermediation by financial advisers. Simple products are gaining in 'market share'.	●	• Comparable to headquarters.	●	• Comparable to headquarters.
Competition among suppliers of financial products changes	●	• The ban reduces the attractiveness of the Netherlands. Entry to the Dutch market becomes more difficult since existing distribution channels cannot be incentivised to distribute financial products. Profit margins after entry are lower due to increased transparency. As the ban only applies to activities in the Dutch market, the international competitive position is not affected. • We expect the effect to be negligible given the availability of direct distribution.	●	• Comparable to headquarters.	●	• Comparable to headquarters.

● Positive ● Neutral ● Negative ● Ambiguous ○ Negligible ○ Small ○ Large

The ban might improve the attractiveness for suppliers of financial products as it enhances trust in financial institutions and financial stability

Potential effects		Headquarters		Subsidiary		Branch
Suppliers of financial products						
The trust in the financial sector is enhanced	Positive, negligible	• The Netherlands becomes more attractive for suppliers of financial goods and services to establish local presence as compared to other countries, since the ban on inducements contributes to public trust in the financial sector. Trust has a beneficial effect on the level of demand. As the ban only applies to activities in the Dutch market, the international competitive position is not affected. • We expect that the effect is negligible.	Positive, small	• Comparable to headquarters.	Positive, small	• Comparable to headquarters.
Financial stability increases	Positive, negligible	• The attractiveness of the Netherlands improves because the ban on inducements contributes to financial stability. • Financial stability is conducive for the attractiveness; please refer to box 1. • We expect this effect to be negligible. The ban on inducements is primarily aimed at consumer protection.	Positive, negligible	• Comparable to headquarters.	Positive, negligible	• Comparable to headquarters.

Positive Neutral Negative Ambiguous Negligible Small Large

The ban on inducements reduces the attractiveness of the Netherlands for financial advisers with respect to locating an office, as the demand for financial advice diminishes

Potential effects		Headquarters		Subsidiary		Branch
Financial advisers						
The demand for financial advice diminishes	Negative, small	• The attractiveness of the Netherlands for financial advisers decreases since the ban on inducements decreases the demand for financial advice. Since the ban only applies to the Dutch market, the attractiveness of the Netherlands is not affected from an international perspective. • We expect this effect to be small. The ban could have a significant effect in the Netherlands, but the ban has negligible effect on international markets.	Negative, large	• The attractiveness of the Netherlands for financial advisers decreases since the ban on inducements decreases the demand for financial advice. • This effect might be large.	Negative, large	• Comparable to subsidiary.

Positive Neutral Negative Ambiguous Negligible Small Large

The ban might improve the attractiveness of the Netherlands for financial advisers as it enhances trust and financial stability

Potential effects		Headquarters		Subsidiary		Branch
Financial advisers						
The trust in the financial sector is enhanced	●	• The Netherlands becomes more attractive for financial advisers as a location compared to other countries since the ban on inducements contributes to public trust in the financial sector. Increased trust can lead to higher demand. As the ban only applies to the Dutch market, the attractiveness of the Netherlands is not affected from an international perspective. • We expect that the effect is negligible.	●	• The Netherlands becomes more attractive for financial advisers as a location compared to other countries since the ban on inducements contributes to public trust in the financial sector. Increased trust can lead to higher demand. • We expect that the effect is small.	●	• Comparable to subsidiary.
Financial stability increases	●	• The attractiveness of the Netherlands slightly improves because the ban on inducements contributes to financial stability. • Financial stability is conducive for the attractiveness (please refer to box 1). • We expect this effect to be negligible. The ban on inducements is primarily aimed at consumer protection.	●	• Comparable to headquarters.	●	• Comparable to headquarters.

Positive Neutral Negative Ambiguous Negligible Small Large

The ban on inducements does not affect the competitive position of suppliers of financial products vis-à-vis competitors on the Dutch market

Potential effects	Competitive position of suppliers of financial products on the Dutch market		Competitive position of Dutch suppliers of financial products on the international markets	
Suppliers of financial products				
The demand for (certain) financial products diminishes	Neutral	• With the exception of EEA investment institutions that provide services with a European passport and from offices located in the Netherlands, the competitive position of financial product suppliers in the Dutch market is not affected by the ban as it applies to all participants in the market. As such, there is a level playing field.	Neutral	• The competitive position of the Dutch suppliers of financial products in the international market is not affected by the ban as it only applies to the Netherlands.
Competition among suppliers of financial products changes	Neutral	• Comparable to the above.	Neutral	• Comparable to the above.
The trust in the financial sector is enhanced	Neutral	• The competitive position of suppliers in the Dutch market is not impacted. All institutions active in the market benefit from improved public trust.	Neutral	• Comparable to the above.
Financial stability increases	Neutral	• The competitive position of suppliers in the Dutch market is not impacted. All institutions active in the market benefit from financial stability.	Positive (negligible)	• Financial institutions from countries with relative high stability can have a competitive advantage.

Positive Neutral Negative Ambiguous Negligible Small Large

The ban on inducements does not affect the competitive position of financial advisers of financial products vis-à-vis competitors on the Dutch market

Potential effects	Competitive position of suppliers of financial products on the Dutch market		Competitive position of Dutch suppliers of financial products on the international markets	
Financial advisers				
The demand for financial advice diminishes	Neutral	• In general, the competitive position of financial advisers in the Dutch market is not affected by the ban as it applies to all participants in the Dutch market. As such, there is a level playing field.	Neutral	• The competitive position of Dutch financial advisers in the international market is not affected by the ban as it applies only to the Netherlands.
The trust in the financial sector is enhanced	Neutral	• The competitive position of financial advisers in the Dutch market is not impacted. All institutions active in the Dutch market benefit from improved public trust.	Neutral	• Comparable to the above.
The trust in the financial sector is enhanced	Neutral	• The competitive position of Dutch financial advisers in the Dutch market is not impacted. All institutions active in the market benefit from financial stability.	Positive	• Financial institutions from countries with relative high stability can have a competitive advantage.

Positive Neutral Negative Ambiguous Negligible Small Large

Ban on inducements: conclusions and recommendations

Conclusions

Dutch financial regulation in comparison to other countries
The Netherlands introduced a broader prohibition of inducements compared to other EU member states.

Attractiveness of the Netherlands
- Suppliers of financial products: for all forms of market entry the effect is ambiguous. The ban leads a reduced demand for financial products. The ban can also increase entry barriers since financial suppliers cannot efficiently incentivise existing distributors to promote their products. However, suppliers benefit from enhanced trust and financial stability.
- Financial advisers: the effect is ambiguous for all forms of market entry. Suppliers benefit from enhanced trust and financial stability. However, the ban might reduce demand for financial advise due to the perceived rise in the costs of advise.

Competitive position in the Netherlands
- Suppliers of financial products: the effect is neutral, as the ban applies to almost all market participants in the Netherlands.
- Financial advisers: the effect is neutral, as the ban applies to all market participants in the Netherlands.

Competitive position of Dutch institutions abroad
- Suppliers of financial products: the ban is unlikely to effect the competitive position of Dutch institutions abroad as the ban only applies to the Netherlands. Suppliers might slightly benefit from increased financial stability in the Netherlands.
- Financial advisers: the ban is unlikely to effect the competitive position of Dutch institutions abroad as the ban only applies to the Netherlands. Suppliers might slightly benefit from increased financial stability in the Netherlands.

Off-setting factors for the effects of the deviation
- The reduced demand for financial products is unlikely to be significant for simple products as financial advise is less necessary for decision making by consumers.

Recommendations

- During the upcoming evaluation of the ban on inducements in 2017, special attention should be paid to the following:
  - The (unintended) effects on the demand for financial advice;
  - The (unintended) effects on the competition;
  - The (unintended) effects on the attractiveness of the Netherlands for entry.

Assessment procedure

In the Netherlands, an elaborate assessment procedure exists for candidates for the position of (supervisory) board and other key positions within financial institutions

Suitability and integrity screening of directors and supervisory board members

Regulatory framework

Board members and supervisory board members of financial institutions have to be screened on suitability and/or integrity. This is the case for financial institutions under the supervision of DNB and/or the AFM from 2015 onwards. Since 2016, the screening obligation is extended to managers of banks and insurers who report directly to the management board and are responsible for activities with a potentially material impact on the institution's risk profile.

Candidates require a positive ruling from the supervisory body before they can take up their new responsibilities. Depending on the type of financial institution, either the DNB or the AFM or both, supervisors are responsible for the screening. The screenings are mandated by several laws, namely: the Pensioenwet (PW), Wet op het financieel toezicht (Wft), Wet toezicht trustkantoren (Wtt), Wet verplichte beroepspensioenregeling (Wvb) and subordinate legislation (DNB, DNBulletin).

The screening

The screening process consists of two elements: integrity screening and suitability screening (DNB).

- **Integrity screening** focuses on the integrity of the proposed candidate and is conducted when he/she is first selected for the potential position. Generally, the integrity screening for a candidate happens only once, i.e. if the candidate receives a go-ahead, he/she does not need to be screened on integrity if proposed for a new position.
- **Suitability screening** focuses on the appropriateness of a candidate to fulfil the proposed position. This screening and its verdict are specific to a particular position; therefore candidates have to be always screened on suitability if they apply to a new job (even if they have been approved for earlier positions). The suitability screening takes the position of the candidate within the organisation into account. For instance, in case of a candidate for a position in the board, the skill set and heterogeneity of the entire board are taken into consideration. The supervisors use a suitability matrix in which competences are scored. The entire board should have the right competences and knowledge. Individual board members do not have to possess all the required competences in themselves. The supervisors duly acknowledge that the board members complement each other (DNB).

In exceptional circumstances, the supervisor can decide that a reassessment is necessary. A reassessment can only take place when there are reasonable grounds for revisiting a previous screening. This may involve a suitability screening, an integrity screening or a combination of the two. In 2015, there were 16 reassessments and over 1900 initial screenings (DNBulletin).

Under normal circumstances, an initial suitability and/or an initial integrity screening takes place upon the proposed appointment. As the legislation concerning the assessment of employees in key positions is already in effect from 2015, initially, all current employees in key positions had to be screened on integrity and suitability.

The assessment procedure consists of a preliminary assessment which might be followed by an interview round

Procedure

Both the integrity and suitability screening might involve two stages – a preliminary assessment and an interview. In the preliminary assessment, the supervisor reviews the information provided by the candidate and other governmental organisations, such as the tax authority and the department of justice. If sufficient information is provided and the supervisor has no further questions, a candidate may receive the go-ahead without an interview. If the supervisor still has questions or if the nature of the position so requires, the candidate is interviewed by the supervisor. During the interview, candidates are assessed by two or three employees of the national supervisor(s), and if relevant, someone from the ECB (DNB).

Representation and recording

Candidates can bring (legal) representatives to the interview. Moreover, DNB is experimenting with the possibility to record the interviews if the person to be screened so prefers (DNB).

Assessment criteria

The 2012 Suitability Policy Rule (Beleidsregel geschiktheid 2012) defines the aspects that must be considered during the assessment of nominees. These aspects can be divided in four categories, namely:

1. Governance, organisation and communication.
2. Products, services and markets in which the institution operates.
3. Sound and ethical operational management.
4. Balanced and consistent decision-making.

For pension funds, seven additional areas are considered:

1. Organisational governance.
2. Relevant laws and regulations.
3. Pension schemes and types.
4. Financial and actuarial aspects, including funding, investments, actuarial principles and reinsurance.
5. Internal control system.
6. Communications and
7. Outsourcing.

(DNB)

Box 8: Most candidates are approved by AFM and DNB

In 2015, 4% of the candidates have been rejected by the DNB. Since the screening procedure is in place, the number of rejected candidates initially doubled from 7% in 2011 to 14% in 2013. However, since 2013, it has decreased to 4% in 2015 (DNBulletin, DNB).

These numbers do not include candidates who withdraw from the process. Interviewees indicate that they and their institution receive an unofficial statement from the supervisor(s) if a candidate is likely to be rejected. Interviewees indicate that in such scenario, candidates are likely to withdraw from the process to prevent an official rejection from the supervisor(s).

The Netherlands is tougher compared to other European countries with the exception of the UK. In most European countries, the screening consists of a purely ‘administrative assessment’

Within Europe, the screening of candidates differs largely. The UK and the Netherlands have the most elaborate assessment regimes

Internationally, the procedure concerning the examination of ‘controlled functions’ is different in the UK and the Netherlands. The Netherlands as well as the UK have an elaborate assessment process which involves an administrative assessment and an interview.

The European context

Several European directives (e.g. CRD IV, Solvency II and MiFID) state that the top management of financial institutions needs to be suitable and trustworthy. Almost all other European countries choose to implement the directives in a less stringent manner compared to the Netherlands and the UK. It is common to only have an ‘administrative assessment’ of the suitability and trustworthiness. During these assessments, the national authorities of European countries mainly focus on candidate experience and written documentation.

Germany

In Germany, the Ministry of Finance (BaFin) and the Deutsche Bundesbank assess the suitability and trustworthiness of the senior managers. This assessment is based on documentation provided by the bank (Gesetz über das Kreditwesen). Previous managerial experience is considered an important element in the assessment. If the candidate has at least three years of managerial experience at an institution of comparable size and type of business, it is assumed that the candidate has the necessary professional qualifications (Van Gelder, 2012).

France

In France, the prudential authority ACPR screens the person effectively managing a financial institution (credit institution, a finance company, an investment firm other than a portfolio management company, a payment institution or an electronic money institution) after appointment. The screening involves a review of the notification of a new appointment and a potential review of additional clarifications or documents from reporting institutions, as requested by ACPR (ACPR). Additionally, a certification exam is obligatory for employees with certain key functions (traders, sales personnel, financial analysts and asset managers). The purpose of this exam, considered an easy one, is to verify a minimal level of knowledge (AMF). Further, there is no limit on the number of times a candidate can take the exam after an initial failure (Van Gelder, 2012).

The UK has an assessment regime comparable to the Netherlands. The main difference between the UK and the Netherlands is the involvement of external senior advisers in the screening procedure

In the UK, external senior advisers are involved in the assessment of candidates for senior positions at large firms. Given the background of these senior nominees, advisers with comparable mature backgrounds are involved (Van Gelder, 2012). However, recent changes in the Netherlands narrow this difference. DNB now involves external experts and its senior management more integrally in the screening process (DNB).

According to interviewees, the Netherlands and the UK deviate from other Western countries regarding the assessment procedure of employees for key positions

Box 9: Regulatory framework in the UK
The UK applies an elaborate screening of candidates for the so-called 'controlled function'. Controlled functions are specified under section 59 of the Financial Services and Markets Act. Among others, the board and supervisory board members fulfil controlled functions. Other controlled functions include the head of risk and compliance committees and compliance and risk positions just below the board.

The candidates have to undergo a 'fit and proper test' in which the FCA assesses the nominees based on their
1. Honesty, integrity and reputation
2. Competence and capability
3. Financial soundness.

According to the FCA, the nominees should have the following skills:
1. Market knowledge.
2. Understanding of the institution's business model and strategy.
3. Understanding of risk management and compliance norms of the institution.
4. Knowledge of finance and financial products.
5. Corporate governance.
6. Understanding of the legal frameworks and regulation.

Only after a positive assessment by the FCA, a nominee can be appointed to his or her controlled function. The assessment is based on the Financial Services and Markets Act (Van Gelder, 2012 and FCA Handbook).

During the interviews, the screening process in the Netherlands was mentioned as tougher than most other countries

Interviewees indicate that the Netherlands has a stringent screening procedure
Eleven interviewees indicated that the Netherlands and the UK deviate strongly from other countries with respect to the assessment of candidates. The procedure in the Netherlands is considered to be relatively tough compared to other countries (except the UK, which is deemed comparable).

According to some interviewees, supervision harmonises within the European Union
Supervision is expected to become more harmonised in the European countries (one interview). Most national regulations are based on European directives and guidelines. The European authorities provide more guidance on how European legislation should be implemented and how the supervision should be arranged. To avoid national deviations from the European directives, among others, Q&A regarding the directives are provided to member states. Further, peer reviews and seminars are intended to at least map the differences but preferably eliminate the differences over time. During the seminars, national supervisors discuss how legislation should be implemented and executed at the national level as well. Moreover, supervision slowly shifts to supranational supervisors, such as the ECB, according to one interviewee.

The interviewees distinguish several potential effects of the elaborate screening procedure. Especially, the reputational risk for candidates was mentioned as a negative consequence of the assessment

Five interviewees state that the screening might affect the reputation of the candidates

According to five interviewees, there is a large negative implication on the reputation of the candidate if he or she does not pass the test. The nominees tend to extensively prepare for the interviews (three interviews). One of the reasons for the time-consuming preparation is that the candidate has to be able to answer a broad variety of questions and should be able give his or her opinion on relevant decisions made in the past (one interview). Further, candidates with an impressive career record do not prefer to be tested by a relatively junior employee of the supervisor(s), according to four interviewees.

According to two interviewees, the elaborate assessment is especially of not much value to foreign financial institutions

According to one interviewee, the screening is problematic for foreign institutions, especially if the board members of the Dutch holding are also the board members of the international firm. This is partly because the preparation for the assessment is quite elaborate while the candidates tend to have a limited amount of time available. For instance, Japanese banks tend to start preparing its candidates a year in advance of the screening. The preparation often involves commercial agencies that help candidates prepare for the screening by the DNB and AFM (two interviews).

According to one interviewee, foreign candidates also seem to experience cultural difficulties during the interviews. For instance, a Southern European candidate might act in a much more amicable manner than what is common in the Netherlands. The supervisor might perceive this differently than what is being intended (two interviews). However, the same interviewee stated that DNB and AFM have indicated that they intend to pay more attention to cultural differences of candidates in the future.

Three interviewees question to what extent the possibility of a fair appeal can be expected

According to four interviewees, the possibilities to object to the rejection of a candidate are limited. A financial institution can object to the conclusion of the supervisor. An objection procedure is a confidential non-public procedure, handled by staff members from a division different from that of the supervisor. Financial institutions do not consider this a fair procedure as they perceive the different division as lenient towards their own colleagues (two interviews). Additionally, a public appeal at the Trade and Industry Appeals Tribunal is possible. Candidates with a negative assessment might not be willing to start this procedure. Moreover, financial institutions are even less inclined to make an appeal against the supervisor because it is not clear whether and how this affects the relationship between the institution and the supervisor (three interviews).

It is also possible to challenge the disapproval in court. This is not considered as a viable option as the chance of winning is rather small. The perception is that a judge is not likely to overrule the opinion of the supervisor (one interview).

According to three interviewees, the screening or threat of rescreening can be used as an instrument that provides the supervisors leverage when they have a conflicting opinion with an institution or when they want something to change outside the scope of law.

However, internationally, the Dutch supervisors are expected to demonstrate relatively fair conduct and make less use of this leverage tool (one interview).

According to some interviewees, the assessment is one reason for foreign financial institutions to avoid the Netherlands. The opinions are mixed regarding the effect on the quality of the employees in key positions

Two interviewees believe there are improvements in the process

Two interviewees indicate that DNB and AFM are actively improving the screening procedure, and are open to feedback e.g. candidates may bring external representatives to the interviews and may choose to record the interview. In addition, they indicate that the screening procedure is improving (two interviews).

According to interviewees, the assessment procedure might pose a barrier for entry into the Dutch market

Foreign financial institutions might see the extensive screening procedure in the Netherlands as a barrier to enter the market (two interviews). According to one interviewee, the assessments lead to an air of uncertainty as to whether senior management candidates for the Dutch office will be approved. Besides, there are costs involved in preparing a candidate for the interview. Senior management of a foreign office often fulfil their positions for a relatively short period. As such, the preparation for an assessment can be costly compared to the time these managers are stationed in the Netherlands. The possibility of being rejected by the supervisor poses a risk for the reputation of the candidates, as mentioned before. This potential reputational risk reduces the attractiveness of the Netherlands as well (two interviews).

Attracting suitable supervisory board members has become more challenging according to interviewees

According to one interviewee, it has become more difficult to attract members to the supervisory board. The reason for this is that the screening poses a reputational threat for potential supervisory board members. Once a candidate is rejected, it might negatively affect his or her standing. One interviewee, however, indicated that candidates with sufficient knowledge are unlikely to avoid these positions. Last year, only 4% of all the candidates failed the assessment. One interviewee argues that the candidates who are discouraged by the prospect of an assessment, are probably ill-suited for the position anyway.

Other interviewees indicate that the assessments help improve the quality of decision-makers

The assessments may have a positive effect on the soundness of the financial institutions as it potentially raises the quality of the (supervisory) board members and other key positions (two interviews). The screening procedures help reduce the lack of knowledge about finance among board members (two interviews).

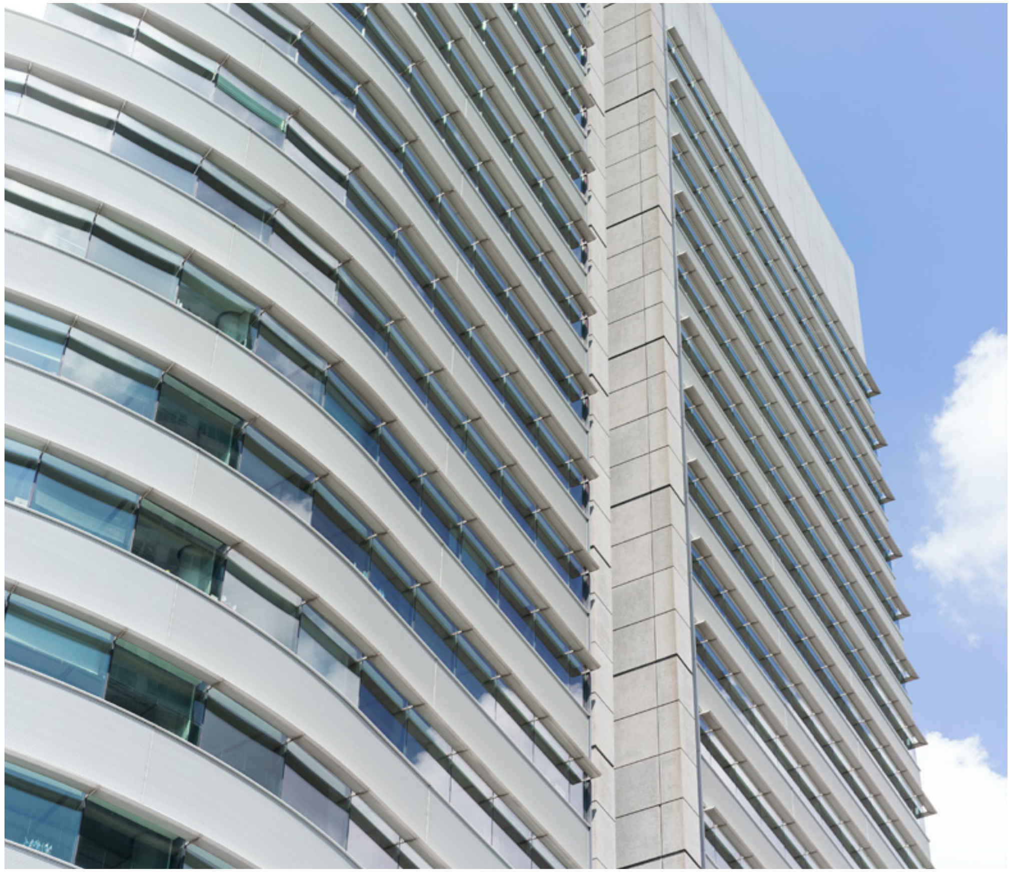
The effect of a stronger screening procedure on the competitive position of Dutch financial institutions is expected to be very small

Box 10: Heterogeneity of the supervisory board

The reputational risk for candidates could lead to a competitive disadvantage. This risk could discourage potential candidates to apply to key positions. This could decrease the number of potential candidates. As a consequence, higher wages need to be offered to attract suitable candidates. It is however doubtful that candidates with deep knowledge of the financial sector will avoid a key position because of a more elaborate assessment.

Reputational risk can potentially diminish the heterogeneity of supervisory boards. Candidates for the supervisory board with a background in other industries might be discouraged by the screening procedure. Consequently, the supervisory boards might become more homogeneous as only persons with a similar background end up becoming a board member. This could be harmful because a diverse supervisory board increases the independence of the supervisory board (Hagendorff and Keasey, 2008). An independent supervisory board decreases risk-taking capacity (Eling and Marek, 2013) and thereby enhances financial stability.

The DNB, however, acknowledges the importance of different skills in the supervisory board. During an individual assessment, the skills and composition of the entire board are taken into consideration (DNB). Nevertheless, still a minimum knowledge of the financial sector is required. If DNB regards the knowledge as too little, it might provide the candidate with the possibility to improve their knowledge of finance and the financial sector by means of training, provided this is finalised within an agreed period of time.



In the Netherlands, a more elaborate screening process of employees in key positions by the supervisor is in place. This elaborate assessment could have an effect on the quality and type of employees in key positions

Regulation applies to?

- Directors/members of the Board of Management at financial institutions under the supervision of DNB and/or the AFM.
- Non-executive directors/members of the Supervisory Board.
- Certain employees occupying key positions.

People in similar positions as mentioned above at branches of financial institutions from the EU, which are active in the Netherlands using a passport.

Potential effects

Increases the quality of employees in key positions

Though financial firms have a commercial incentive to select suitable employees for key positions, there are indications that the selection process is not optimal. Regulations regarding the screening of key staff could contribute to the quality of key employees.

Makes it harder to attract employees for key positions

The reputation of potential candidates can be harmed if they are rejected by one of the supervisors. This reputational risk can discourage potential candidates to apply for (or accept) a key position. Consequently, the amount of potential candidates may decrease.

Employees in key positions become more homogeneous

The employees in key positions can tend to become more homogeneous due to the uniformity of the selection process. Candidates with non-financial backgrounds but complementary skills are less likely to occupy a key position as the supervisors require knowledge of financial products and the financial sector.

Reputation of the institution

Financial institutions under thorough supervision can have a reputational advantage (please refer to box 2).

Raises costs and uncertainty

The (preparations for the) assessments are time-consuming and raise the recruitment costs for financial institutions. Uncertainties regarding the outcomes of the assessment also introduce uncertainty in the recruitment process.

Increases financial stability

Higher quality and integrity of key employees are expected to contribute to robust leadership and internal supervision which in turn should contribute to financial stability.

Summary of the effect of a more stringent assessment procedure on the attractiveness of the Netherlands and the competitive position of Dutch financial institutions (in next pages, we explain the effects)

Potential effects	The attractiveness for a foreign fin. inst. to headquarters in the Netherlands	The attractiveness for a foreign fin. inst. to locate a subsidiary in the Netherlands	The attractiveness for a foreign fin. inst. to locate a branch in the Netherlands	Competitive position of Dutch fin. inst. in the Dutch market	Competitive position of Dutch fin. inst. in the international market
Increases the quality of employees in key positions	Positive	Positive	Negative	Positive	Positive
Greater difficulty to attract employees to key positions	Negative	Negative	Positive	Negative	Negative
Employees in key positions become more homogeneous	Negative	Negative	Positive	Negative	Negative
Reputation of the institution	Positive	Positive	Negative	Positive	Positive
Raises the costs and uncertainty	Negative	Negative	Positive	Neutral	Neutral
Increases financial stability	Positive	Positive	Positive	Neutral	Positive

Positive Neutral Negative Ambiguous Negligible Small Large

More stringent assessment procedures can be slightly positive for headquarters and subsidiaries located in the Netherlands, as it may improve the quality of staff in key positions

Potential effects		Headquarters		Subsidiary		Branch
Increases the quality of employees in key positions	Positive	• The Netherlands is more attractive as a location for headquarters compared to other countries. An increase in the quality of the key employees at headquarters could improve the performance of the financial institution. In the Netherlands headquarters have a competitive advantage vis-à-vis branches. • The effect is negligible because we expect that financial institutions already have a commercial incentive to select suitable employees.	Positive	• Subsidiaries have a competitive advantages vis-à-vis branches due to the increases in quality. • This effect is negligible.	Negative	• The Netherlands is slightly less attractive as a branch location as the local competitors are subject to the stringent assessment procedure. Competitors might have a competitive advantage, since the quality of their employees is higher. • The effect is negligible for the same reasons as given by headquarters.

Positive Neutral Negative Ambiguous Negligible Small Large

The relative attractiveness of the Netherlands for financial institutions to locate their headquarters and subsidiaries is negatively affected by the screening as it becomes harder to attract key employees

Potential effects		Headquarters		Subsidiary		Branch
Greater difficulty to attract employees for key positions	Negative	• The difficulty to attract employees for key positions creates a competitive disadvantage both on the international markets and the national market, decreasing the attractiveness of the Netherlands. • We expect this effect to be negligible as most serious candidates would not be easily discouraged.	Negative	• The Netherlands is slightly less attractive as a subsidiary location as it will be harder for the subsidiaries to attract suitable employees for key positions compared to their local competitors which have branch status and are not subject to the stringent regulation. • We expect this effect to be negligible as most serious candidates would not be easily discouraged.	Positive	• The Netherlands is slightly more attractive as a branch location compared to other countries, since it might be easier for branches of foreign banks in the Netherlands to attract employees to key positions compared to their local competitors. This is because foreign branches are exempt from the assessment procedure in the Netherlands. • We expect this effect to be negligible as most serious candidates would not be easily discouraged.
Employees in key positions become more homogeneous	Negative	• The Netherlands is slightly less attractive, since a tendency to a more homogeneous workforce in key positions can lead to a competitive disadvantage on national and international markets. • We expect this effect to be negligible because the supervisors are likely to take heterogeneity into account in their assessment.	Negative	• The Netherlands is slightly less attractive as a subsidiary location compared to other types of entry, since subsidiaries will have a more homogeneous workforce in key positions, which leads to a competitive disadvantage. • We expect that this effect will be negligible because DNB acknowledges the importance of heterogeneity and is likely to take this into account during the assessments.	Positive	• The Netherlands is slightly more attractive as a branch location compared to other countries, since branches can attract a more heterogeneous workforce in key positions, which provides them with a competitive advantage. • We expect that this effect will be negligible because DNB acknowledges the importance of heterogeneity and is likely to take this into account during the assessments.

Positive Neutral Negative Ambiguous   Negligible Small Large

The effect of more stringent assessment procedures in terms of reputation, costs and financial stability is ambiguous, and depends on the type of market entry (1/2)

Potential effects		Headquarters		Subsidiary		Branch
Reputation of the institution	●	• The Netherlands is slightly more attractive as a location for headquarters compared to other countries since a financial institution under tough supervisory oversight can have a reputational advantage; please refer to box 2. The Netherlands is slightly more attractive as a location for headquarters, since a financial institution under tough supervisory oversight can have a reputational advantage on international markets; please refer to box 2. The attractiveness also increases because headquarters have a better reputation due to the extensive procedure vis-à-vis foreign branches located in the Netherlands. • We expect this effect to be negligible.	●	• Comparable to headquarters.	●	• The Netherlands is slightly less attractive as a branch location compared to other countries since competitors might have a reputational advantage due to stricter regulation. • We expect this effect to be negligible.

● Positive ● Neutral ● Negative ● Ambiguous ○ Negligible ○ Small ○ Large

The effect of more stringent assessment procedures in terms of reputation, costs and financial stability is ambiguous, and depends on the type of market entry (2/2)

Potential effects		Headquarters		Subsidiary		Branch
Raises the costs and uncertainty	Negative	• The Netherlands is less attractive for locating headquarters compared to other countries due to the increased costs and uncertainty of recruiting the relevant key team members. Furthermore, branches have a competitive advantage within the Netherlands as they are not subject to the regulation. • We expect that the effect is negligible. Only a small percentage of candidates is not approved by the supervisor(s).	Negative	• The Netherlands is slightly less attractive as a subsidiary location compared to other countries since the costs and uncertainty are higher and there is a competitive disadvantages vis-à-vis branches. • We expect that the effect is negligible. Only a small percentage of candidates is not approved by the supervisor(s).	Positive	• The Netherlands is slightly more attractive as a subsidiary location compared to other countries since there is a competitive advantages vis-à-vis local competitors subject to the regulation. • We expect that the effect is negligible. Only a small percentage of candidates is not approved by the supervisor(s).
Increases financial stability	Positive	• The Netherlands is more attractive because the elaborate screening contributes to financial stability compared to local competitors not subject to the regulation and international competitors. • Financial stability is conducive to attractiveness; please refer to box 1 • We expect this effect to be negligible.	Positive	• Comparable to headquarters.	Positive	• Comparable to headquarters.

Positive Neutral Negative Ambiguous   Negligible Small Large

The effect on the competitive position of Dutch banks and insurers vis-à-vis competitors is ambiguous (1/2)

Potential effects	Competitive position of Dutch financial institutions in the Dutch market		Competitive position of Dutch financial institutions in the international markets	
Increases the quality of employees in key positions	Positive	• Dutch financial institutions might face a competitive advantage in the Dutch market compared to financial institutions that are active in the Dutch market using a passport. • We expect the effect to be negligible, because financial institutions already have a commercial incentive to invest in the quality of employees in the absence of regulation. • Moreover, we do not expect that the supervisor is better equipped than the financial institutions to select suitable employees.	Positive	• Comparable to Dutch market. • The effect might be strong, because most foreign competitors undergo a less elaborate screening. • We expect this effect to be negligible, but bigger than in the Dutch market because the number of competitors with a less elaborate screening is higher in international markets compared to the Dutch market.
Greater difficulty to attract employees to key positions	Negative	• Dutch financial institutions might face a competitive disadvantage in the Dutch market compared to financial institutions active in the market using a passport since it is more difficult to attract suitable employees to key positions. • We expect this effect to be negligible as most potential candidates will likely have sufficient knowledge.	Negative	• Comparable to Dutch market. • We expect this effect to be negligible, but bigger than in the Dutch market because the number of competitors with less elaborate screening is higher in international markets compared to the Dutch market.
Employees in key positions become more homogeneous	Negative	• Dutch financial institutions might face a competitive disadvantage in the Dutch market compared to financial institutions active in the market using a passport since a tendency to a more homogeneous senior management has several competitive disadvantages. • We expect this effect to be negligible as the supervisors take heterogeneity into account in their assessment.	Negative	• Comparable to Dutch market. • We expect this effect to be negligible, but bigger than in the Dutch market because the number of competitors with less elaborate screening is higher in international markets compared to the Dutch market.

Positive Neutral Negative Ambiguous Negligible Small Large

The effect on the competitive position of Dutch banks and insurers vis-à-vis competitors is ambiguous (2/2)

Potential effects	Competitive position of Dutch financial institutions in the Dutch market	Competitive position of Dutch financial institutions in the international markets
Reputation of institution	• Dutch financial institutions may have a competitive advantage in the Dutch market compared to institutions using a passport. The stricter regulation of Dutch financial institutions might have a positive effect on the reputation. • The effect is negligible.	• Comparable to Dutch market. • The effect might be strong because most foreign competitors undergo a less elaborate screening.
Raises the costs and uncertainty	• The competitive position of Dutch financial institutions in the Dutch market is not impacted. The additional uncertainty caused by the elaborate screening is a minor issue, given that there is already a team in place and that an established institution is likely to be more stable compared to a market entry situation. • Costs associated with the preparation for a screening do not have a significant effect on the competitive position of Dutch financial institutions.	• Dutch banks have a competitive disadvantage as the costs are higher and the uncertainty larger.
Increases financial stability	• The competitive position of Dutch financial institutions in the Dutch market is not impacted. All institutions active in the Dutch market benefit from financial stability.	• Dutch banks have a competitive advantage if the default risk of financial institutions is interrelated at the national level. In this case, the funding costs of financial institutions is lower in a country with a stable financial system.

Positive Neutral Negative Ambiguous

Negligible Small Large

Assessment procedure: conclusions and recommendations

Conclusions

Dutch financial regulation in comparison to other countries

The Netherlands has a more elaborate assessment procedure of staff at financial institutions compared to most other countries.

Attractiveness of the Netherlands

- Headquarters and subsidiaries: the net effect is ambiguous. These entry forms may face difficulty finding employees, higher costs and uncertainty, but on the other hand can benefit from increased performance due to higher qualified staff.
- Branches: the net effect is ambiguous. Branches are exempt from assessments and as such the Netherlands can be more attractive for this form of market entry. However, branches too require highly qualified staff for commercial success and trust.

Competitive position in the Netherlands

- The net effect is ambiguous. On the Dutch market financial institutions have similar difficulties and benefits.
- Branches of foreign financial institutions may benefit from exemption versus other entry forms, but this can impact their reputation and performance.

Competitive position of Dutch institutions abroad

- The net effect is ambiguous. Abroad Dutch financial institutions may benefit from having highly qualified staff, but also face the disadvantages of stricter assessments in the Netherlands versus foreign competitors.

Off-setting factors for the effects of the deviation

- Financial institutions have a commercial incentive to select highly qualified staff with diverse backgrounds, as this benefits performance and enhances their reputation.

Recommendations

- We recommend that the legislation governing assessment procedures should be aligned at a European level to prevent regulatory arbitrage and a non level playing field.

Appendices

Appendix 1: Literature (1/3)

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Appendix 2: List of interviewees

Interviews held with external parties and PwC counterparts

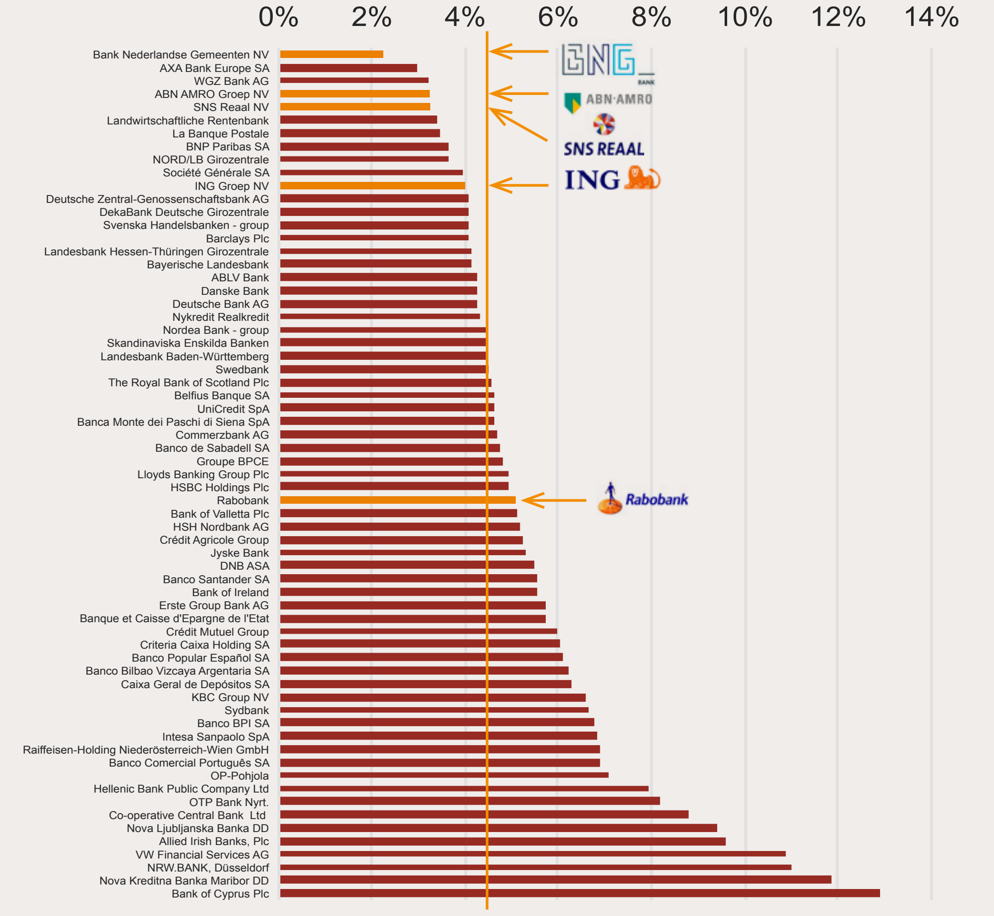
Name	Organisation
Erik Schouten	Aegon
Johan de Groot, Ellen Boelema	Autoriteit Financiële Markten (AFM)
Michiel Bijlsma, Sander van Veldhuizen	Centraal Plan Bureau (CPB)
Hans Janssen Daalen	Dutch Fund and Asset Management Association (DUFAS)
Edwin Herskovic, Arlette Koedam	Foreign Bankers Association (FBA)
Geert Raaijmakers	NautaDulith
Floris Mreijen, Edward Feitsma	Nederlandse Vereniging van Banken (NVB)
Michel de Jonge	PGGM
Pepijn Meeuwissen	Towers Watson
Arnoud Boot	Universiteit van Amsterdam
Sweder van Wijnbergen	Universiteit van Amsterdam
Rens van Tilburg	Universiteit van Utrecht, Sustainable Finance Lab
Fred Treur	Verbond van Verzekeraars
Theo Andringa	Vereniging van Vermogensbeheerders & Adviseurs (VV&A)
Martien Lubberink	Victoria University
Anthony Kruisinga, Bas van de Pas, Edwin van Kasteren, Frans Oomen, and Gerwin Naber	PwC
Jochen Blaffert, Olivier Sueur, Patrick Heisen, Remco van der Linden and Ronald van Remoortere	PwC
Wim Koeleman	PwC
Anonymous*	Anonymous*

* One interviewee accepted to be interviewed on the condition that we would not state his or her name and the name of the associated institution/firm

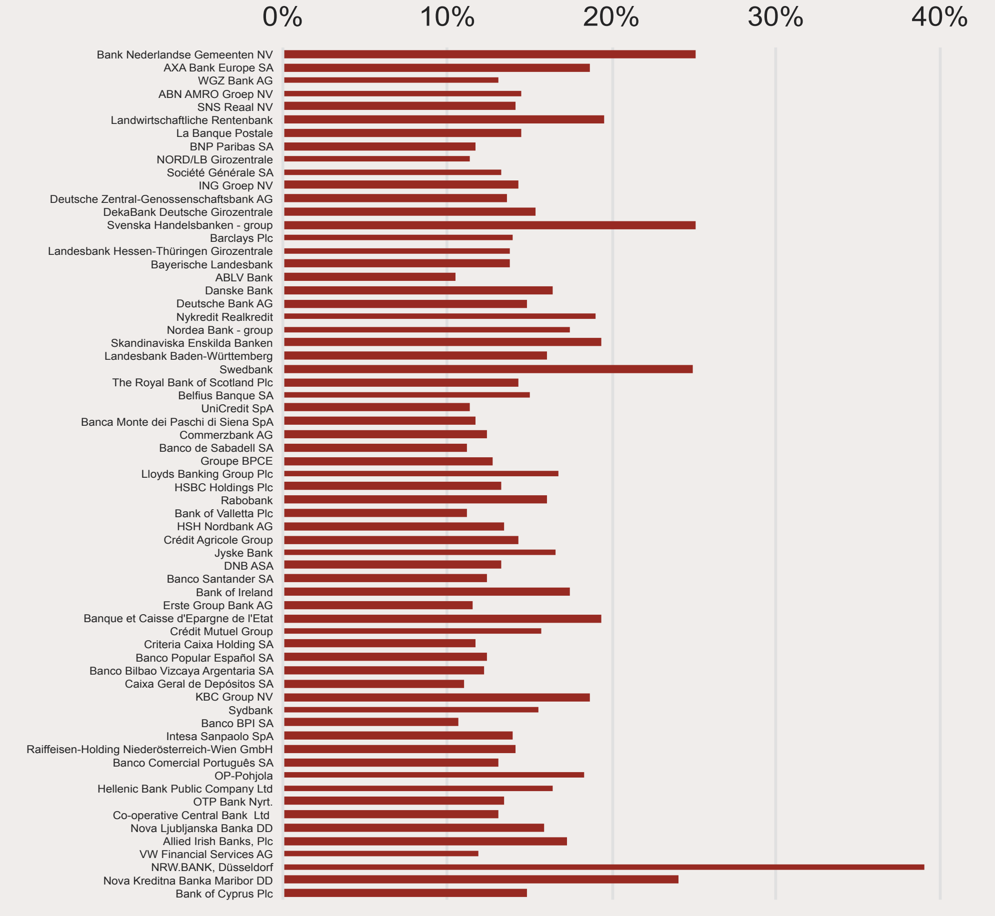
Appendix 3: Graph

The leverage ratios of three Dutch system banks are relatively low compared to the system banks of other EU countries

Leverage ratio of selected EU-system banks, June 2015



Tier-1 capital ratio of selected EU-system banks, June 2015



Source: European Banking Association, EU-wide transparency exercise 2015